

Office of Inspector General


U.S. Department of Homeland Security
Washington, DC 20528



**Homeland
Security**

November 15, 2005

MEMORANDUM FOR: The Honorable Michael Chertoff
Secretary

FROM: 
Richard L. Skinner
Inspector General

SUBJECT: Independent Auditors' Report on DHS' FY 2005 Financial Statements

The attached report presents the results of the Department of Homeland Security's (the Department) financial statement audits for fiscal year FY 2005 and FY 2004. These audits were required by the *Accountability of Tax Dollars Act of 2002*. This report is incorporated into the *Department's FY 2005 Performance and Accountability Report*. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits.

Unfortunately, the Department made little or no progress to improve its overall financial reporting during FY 2005. KPMG was unable to provide an opinion on the Department's balance sheet, and the number of material weaknesses remains 10. The Transportation Security Administration (TSA), which received an unqualified opinion in 2004 from its stand-alone audit, was unable to complete its statements by the end of scheduled fieldwork this year, primarily due to a systems conversion. We have extended TSA's audit for an additional 30 days.

Summary

KPMG was unable to express an opinion on the Department's consolidated balance sheet as of September 30, 2005, and on the consolidated financial statements as of and for the year ended September 30, 2004. The disclaimer was due primarily to financial reporting problems at 5 bureaus. The FY 2005 auditors' report discusses 10 material weaknesses, 2 other reportable conditions in internal control, and instances of non-compliance with 7 laws and regulations, as follows:

Reportable Conditions That Are Considered To Be Material Weaknesses

- A. Financial Management Oversight
- B. Financial Reporting
- C. Financial Systems Security
- D. Fund Balance with Treasury
- E. Property, Plant, and Equipment

- F. Operating Materials and Supplies
- G. Undelivered Orders, Accounts and Grants Payable, and Disbursements
- H. Actuarial Liabilities
- I. Budgetary Accounting
- J. Intragovernmental and Intradepartmental Balances

Other Reportable Conditions

- K. Environmental Liabilities
- L. Custodial Revenue and Drawback

Non-compliance With Laws And Regulations

- M. Federal Managers' Financial Integrity Act of 1982 (FMFIA)
- N. Federal Financial Management Improvement Act of 1996 (FFMIA)
- O. Federal Information Security Management Act (Electronic Government Act of 2002)
- P. Single Audit Act Amendments of 1996, and Laws and Regulations Supporting OMB Circular No. A-50, Audit Follow-up, as revised
- Q. Improper Payments Information Act of 2002
- R. DHS Financial Accountability Act of 2004
- S. Government Performance and Results Act of 1993

Moving DHS' Financial Management Forward

Financial management at the Department continued to falter during FY 2005, primarily due to problems at Immigration and Customs Enforcement (ICE) and the Coast Guard. However, TSA, State and Local Government Coordination and Preparedness (SLGCP), and Emergency, Preparedness and Response (EP&R) also experienced difficulties that they could not overcome by the reporting deadline, and they joined ICE and the Coast Guard in contributing to the Department's disclaimer of opinion. Those difficulties included: a systems conversion at TSA, problems involving SLGCP's accounting service provider, and Hurricane Katrina, which stretched EP&R's accounting resources late in the fiscal year despite its best efforts to support the financial statement audit. With focused management attention, we believe that TSA, SLGCP, and EP&R can get back on track for FY 2006.

ICE and the Coast Guard face much deeper problems, and the accounting problems at ICE further affect the bureaus it services. The auditors reported that financial management at ICE was ineffective and used unreliable processes and procedures for accounting and financial reporting. The auditors further reported that weaknesses in ICE's controls might have allowed ICE and the components it serviced to violate the Antideficiency Act. In particular, ICE had significant problems with respect to the completeness and accuracy of its recorded obligations and their timely recording.

The auditors reported that the Coast Guard did not have an organizational structure that fully supported the development and implementation of effective policies, procedures, and internal controls. Management acknowledged to the auditors that longstanding procedural, control, personnel, and cultural issues existed and had impeded their progress in addressing this structural weakness. The auditors reported that the Coast Guard's personnel rotation policy made it difficult

for the Coast Guard's Chief Financial Officer (CFO) to institutionalize internal controls related to financial management and reporting that were outside his direct organization. Within the Coast Guard's CFO organization, the auditors reported that financial reporting processes were complex and labor-intensive.

Although the Department inherited many of the reported conditions, the Department's CFO is ultimately responsible for ensuring that progress is made in financial management. The auditors reported that the Department's CFO office did not provide effective oversight of bureau corrective action plans to ensure their development, implementation, and successful completion.

DHS executive managers have the authority to set priorities and demand the corrective action for both Departmental and bureau personnel. Their active involvement is critical to moving financial management forward at DHS.

* * * * *

KPMG is responsible for the attached auditor's report dated November 14, 2005, and the conclusions expressed in the report. We do not express opinions on the financial statements or internal control or conclusions on compliance with laws and regulations.

Consistent with our responsibility under the Inspector General Act, we are providing copies of this report to appropriate congressional committees with oversight and appropriation responsibilities over the Department. In addition, we will post a copy of the report on our website for public dissemination.

We request that a corrective action plan that demonstrates DHS' progress in addressing the report's recommendations be provided to us within 90 days of the date of this letter.

We appreciate the cooperation extended to the auditors by DHS' financial offices. Should you have any questions, please call me, or your staff may contact J. Richard Berman, Assistant Inspector General for Audits, at 202-254-4100.

Attachment



KPMG LLP
2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

Secretary and Inspector General
U.S. Department of Homeland Security:

We were engaged to audit the accompanying consolidated balance sheets of the U.S. Department of Homeland Security (DHS) as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2004 (referred to herein as "consolidated financial statements"). We were also engaged to consider DHS' internal control over financial reporting and to test DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these financial statements. We were not engaged to audit the accompanying consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2005.

Summary

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the DHS consolidated balance sheet as of September 30, 2005 and on the consolidated financial statements as of and for the year ended September 30, 2004.

Our fiscal year 2005 consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

Reportable Conditions That Are Considered To Be Material Weaknesses

- A. Financial Management Oversight
- B. Financial Reporting
- C. Financial Systems Security
- D. Fund Balance with Treasury
- E. Property, Plant, and Equipment
- F. Operating Materials and Supplies
- G. Undelivered Orders, Accounts and Grants Payable, and Disbursements
- H. Actuarial Liabilities
- I. Budgetary Accounting
- J. Intragovernmental and Intradepartmental Balances

Other Reportable Conditions

- K. Environmental Liabilities
- L. Custodial Revenue and Drawback



The results of our tests of fiscal year 2005 compliance with certain provisions of the following laws, regulations, contracts, and grant agreements disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*:

- M. *Federal Managers' Financial Integrity Act of 1982 (FMFIA)*
- N. *Federal Financial Management Improvement Act of 1996 (FFMIA)*
- O. *Federal Information Security Management Act (Electronic Government Act of 2002)*
- P. *Single Audit Act Amendments of 1996*, and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up*, as revised
- Q. *Improper Payments Information Act of 2002*
- R. *DHS Financial Accountability Act of 2004*
- S. *Government Performance and Results Act of 1993*

DHS financial management systems did not substantially comply with the FFMIA Section 803(a) requirements related to compliance with Federal financial management system requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2005, and we were not engaged to audit the accompanying consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2005. Accordingly, other internal control matters and other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the September 30, 2005 consolidated balance sheet, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

The following sections discuss the reasons why we are unable to express an opinion on the accompanying DHS consolidated balance sheet as of September 30, 2005 and on the consolidated financial statements as of and for the year ended September 30, 2004; our consideration of DHS' internal control over financial reporting; our tests of DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

Report on the Financial Statements

We were engaged to audit the accompanying consolidated balance sheets of the U.S. Department of Homeland Security (DHS) as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2004. We were not engaged to audit the accompanying consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2005.

Immigration and Customs Enforcement (ICE), did not adequately maintain its accounting records during fiscal year 2005, or the accounting records of other DHS components – United States Citizenship and Immigration Service (USCIS), Science and Technology (S&T), Information Analysis and Infrastructure Protection (IAIP), DHS Management, and Border and Transportation Security (BTS) Headquarters (referred to herein as “DHS-ICE components”), for which ICE is the accounting service provider. ICE management was unable to provide sufficient evidential matter that supported the balance sheet accounts of ICE and DHS-ICE components as presented in the DHS consolidated balance sheet at September 30, 2005; or make knowledgeable representation of facts and circumstances regarding accounting and budgetary



transactions that occurred in fiscal year 2005. Throughout the year, and at September 30, 2005, ICE did not perform timely reconciliations of balance sheet accounts or complete its investigation of potential errors in the financial statements that may materially affect the fair presentation of the DHS consolidated financial statements, at September 30, 2005; and therefore, DHS management was unable to represent that the ICE and DHS-ICE component balance sheets are fairly stated as of September 30, 2005. The total assets of ICE and DHS-ICE components, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, are \$5.8 billion or 5.1 percent of consolidated total assets.

The United States Coast Guard (Coast Guard), was unable to provide adequate supporting documentation during fiscal year 2005, particularly with respect to actuarially-derived liabilities, operating materials and supplies, undelivered orders, certain categories of property, plant and equipment, transactions related to the Coast Guard's fund balance with Treasury, and changes in net position and adjustments made as part of Coast Guard's financial reporting process, as presented in the accompanying DHS consolidated balance sheet at September 30, 2005. Adequate evidential matter in support of recorded transactions was not available in all cases and corrective action was not taken prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*. Because of the significance of these balances, DHS management was unable to represent that the Coast Guard's balance sheet as of September 30, 2005, is fairly stated. The total assets of Coast Guard, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, are \$11.4 billion or 9.9 percent of consolidated total assets.

State and Local Government Coordination and Preparedness (SLGCP) was unable to resolve discrepancies identified in the data underlying the calculation of its grants payable liability, and the related effect on net position, if any, at September 30, 2005, prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*. SLGCP grants payable, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, is \$171 million or 0.2 percent of consolidated total liabilities.

The Transportation Security Administration (TSA) was unable to fully reconcile and support the accuracy and completeness of its accounts payable with the public and net position prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*. TSA accounts payable with the public and net position, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, are \$851 million or 1.2 percent of consolidated total liabilities, and \$2.4 billion or 5.4 percent of consolidated total net position, respectively.

Emergency Preparedness and Response (EPR) was unable to fully support the accuracy and completeness of certain components of its deferred revenue and accounts payable, and the related effect on net position, if any, prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*. These liabilities, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, are \$1.7 billion or 2.4 percent of consolidated total liabilities.

DHS was unable to reconcile intragovernmental transactions and balances, prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*, totaling \$1.6 billion, with other Federal trading partners, as of September 30, 2005. In addition, DHS omitted several financial statement note disclosures required by OMB Circular No. A-136, *Financial Reporting Requirements, Part A, Form and Content of the Performance and Accountability Report*.

As discussed above, we were unable to obtain appropriate representations from DHS management with respect to the accompanying DHS consolidated balance sheet as of September 30, 2005, and were unable to determine the effect of the lack of such representations on DHS' financial position as of September 30, 2005. Because of the matters discussed in the six preceding paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying DHS consolidated balance sheet as of September 30, 2005.



We were not engaged to audit the accompanying consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2005, and accordingly, we do not express an opinion on those financial statements.

Regarding the fiscal year 2004 consolidated financial statements, ICE did not adequately maintain its accounting records during fiscal year 2004, particularly with respect to balances transferred in from legacy agencies, intradepartmental and intragovernmental agreements and transactions, suspense accounts, costs and budgetary transactions, thus requiring extensive reconciliation and adjustment of these and other accounts at year end, which ICE was unable to complete. Also, ICE management was unable to provide evidential matter or was not able to make knowledgeable representation of facts and circumstances, regarding certain transactions occurring in fiscal year 2004. DHS was unable to complete and review the accompanying fiscal year 2004 consolidated financial statements, or reconcile its intragovernmental balances, prior to the completion of our procedures. In addition, we were unable to complete audit procedures over certain costs and budgetary transactions of the Coast Guard for the year ended September 30, 2004. For fiscal year 2004, OMB required that federal agencies submit audited financial statements by November 15, 2004. It was impracticable to extend our audit procedures sufficiently to determine the extent to which the consolidated financial statements as of and for the year ended September 30, 2004, may have been affected by these conditions.

Because of the matters discussed in the previous paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying consolidated financial statements of DHS as of and for the year ended September 30, 2004.

As discussed in Note 30, DHS restated its fiscal year 2004 consolidated financial statements to correct an error in accounting for budgetary obligations related to the EPR National Flood Insurance Program as previously reported in DHS' fiscal year 2004 consolidated financial statements. We were not engaged to audit the restatement discussed in Note 30, and accordingly, we have not concluded on the appropriateness of this accounting treatment or the restatement of the fiscal year 2004 financial statements.

The information in the Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), and Required Supplementary Information (RSI) sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Circular No. A-136. We were unable to complete limited procedures over MD&A, RSSI, and RSI as prescribed by professional standards, because of the limitations on the scope of our audit described in the previous paragraphs of this section of our report. Certain information presented in the MD&A, RSSI, and RSI is based on fiscal years 2005 and 2004 consolidated financial statements on which we have not expressed an opinion. We did not audit the MD&A, RSSI, and RSI and, accordingly, we express no opinion on it. However, in fiscal years 2005 and 2004, we noted that DHS did not reconcile nonfiduciary accounts with its trading partners, as specified by OMB requirements, which could affect the intragovernmental information presented in RSI. In fiscal year 2004, we also noted that DHS did not present as RSI a schedule of budgetary resources by major budgetary account, as required.

The information in the Executive Summary, Performance Information, Other Accompanying Information, and Appendices sections of DHS' *Fiscal Year 2005 Performance and Accountability Report* are presented for purposes of additional analysis, and is not a required part of the consolidated financial statements. This information has not been subjected to auditing procedures, and accordingly, we express no opinion on it.

Internal Control over Financial Reporting

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by



the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect DHS' ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted certain matters, described in Appendices I and II involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable conditions A through J presented in Appendix I are material weaknesses. Appendix II represents other reportable conditions K and L. As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2005, and accordingly, other internal control matters may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the September 30, 2005 consolidated balance sheet, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

* * * * *

A summary of the status of fiscal year 2004 reportable conditions is included as Appendix IV.

We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of DHS in a separate letter dated November 15, 2005.

Internal Controls over Required Supplementary Stewardship Information and Performance Measures

We noted certain significant deficiencies in internal control over RSSI, discussed in Appendix I that, in our judgment, could adversely affect DHS' ability to collect, process, record, and summarize RSSI. With respect to the design of internal controls relating to existence and completeness assertions over performance measures determined by management to be key and reported in the MD&A section of DHS' *Fiscal Year 2005 Performance and Accountability Report*, we noted certain deficiencies in internal control over reported performance measures, discussed in Appendix I that, in our judgment, could adversely affect DHS' ability to collect, process, record, summarize and report performance measures in accordance with management's criteria.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2005, and accordingly, other internal control matters affecting RSSI and performance measures may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the September 30, 2005 consolidated balance sheet, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

Compliance and Other Matters

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the FFMIA, disclosed six instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described in Appendix III.

The results of our tests of compliance with certain provisions of other laws and regulations, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.



The results of our tests of FFMIA, disclosed instances where DHS' financial management systems did not substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and recording of financial transactions in accordance with the United States Government Standard General Ledger, that are presented in Appendices I and II.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2005, and accordingly, other instances of non-compliance with laws, regulations, contracts, and grant agreements may have been identified and reported, had we been able to perform all procedures necessary to express an opinion on the September 30, 2005 consolidated balance sheet, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

Additional Matter. ICE management represents that they intend to initiate a review over the completeness of obligations recorded in its accounting records that may identify instances of violations of the *Antideficiency Act*, or other violations of appropriation law that may have occurred during fiscal year 2005, and have not been reported as required by Federal government regulations.

Management's Response to Internal Control and Compliance Findings

DHS management has indicated, in a separate letter immediately following this report that it concurs with the findings presented in Appendices I, II and III of our report. Further, they have responded that they will take corrective action, as necessary, to ensure that the Chief Financial Officer, and the respective bureau management, within DHS address the matters presented herein.

Responsibilities

Management's Responsibilities. The *Government Management Reform Act of 1994* (GMRA), *Accountability of Tax Dollars Act of 2002*, and *Government Corporation Control Act* require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these requirements, DHS prepares and submits financial statements in accordance with Part A of OMB Circular No. A-136.

DHS management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Preparing the MD&A (including the performance measures), RSI, and RSSI;
- Establishing and maintaining internal controls over financial reporting; and
- Complying with laws, regulations, contracts, and grant agreements, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

Auditors' Responsibilities. As discussed in our report on the financial statements, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the DHS consolidated balance sheet as of September 30, 2005, or the consolidated financial statements as of and for the year ended September 30, 2004.



In connection with our fiscal year 2005 engagement, we considered DHS' internal control over financial reporting by obtaining an understanding of DHS' internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our procedures. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our engagement was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon. Further, other matters involving internal control over financial reporting may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS consolidated balance sheet as of September 30, 2005, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

As required by OMB Bulletin No. 01-02, in fiscal year 2005, we considered DHS' internal control over RSSI by obtaining an understanding of DHS' internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over RSSI and, accordingly, we do not provide an opinion thereon. Further, other matters involving internal control over RSSI may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS consolidated balance sheet as of September 30, 2005, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

OMB Bulletin No. 01-02 requires auditors, with respect to internal control related to performance measures determined by management to be key and reported in the MD&A and Performance sections, to obtain an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal controls over performance measures and, accordingly, we do not provide an opinion thereon. As discussed in our report on the financial statements, we were unable to complete procedures over the MD&A and performance measures presented in DHS' *Fiscal Year 2005 Performance and Accountability Report*.

In connection with our fiscal year 2005 engagement, we performed tests of DHS' compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the consolidated balance sheet amounts as of September 30, 2005, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the DHS. Other matters involving compliance with laws, regulations, contracts, and grant agreements may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS consolidated balance sheet as of September 30, 2005, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether DHS' financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. Other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS consolidated balance sheet as of September 30, 2005, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.



Distribution

This report is intended for the information and use of DHS management, DHS Office of Inspector General, OMB, Government Accountability Office, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 14, 2005

Independent Auditors' Report

Appendix I – Material Weaknesses in Internal Control

A. Financial Management and Oversight

Background: In fiscal year 2004, we reported that financial management and oversight at Immigration and Customs Enforcement (ICE) was a material weakness, principally because its financial systems, processes, and control activities were inadequate to provide accounting services to itself and five other substantial Department of Homeland Security (DHS or the Department) components – U.S. Citizenship and Immigration Services (CIS), Science and Technology (S&T), Information Analysis and Infrastructure Protection (IAIP), Management, and Border and Transportation Security (BTS) Headquarters (referred to herein as “DHS-ICE components”). We also reported that weaknesses in financial management oversight hinder the United States Coast Guard’s (Coast Guard) ability to prepare accurate, complete, and timely financial information.

In fiscal year 2004, we also reported that the DHS Chief Financial Officer (CFO) and his staff were challenged by a myriad of issues related to the inception of the Department, many of which were unique matters related to the set-up of the consolidated financial processes of DHS as a single operating entity. The DHS Office of the CFO (OCFO) has taken several positive steps in fiscal year 2005 toward correcting conditions we reported last year, e.g., hired a deputy CFO and additional personnel, prepared guidance and policies, implemented automated monitoring controls, and undertook a self review to improve its controls and processes. In addition, the OCFO implemented new policies and procedures to comply with the *DHS Financial Accountability Act of 2004*, which requires DHS management to provide an assertion on the effectiveness of internal control over financial reporting in fiscal year 2005.

However, the combination of conditions that exist in ICE and DHS-ICE components, the Coast Guard and the OCFO cause an organizational material weakness in financial management and oversight. The operations of ICE and DHS-ICE components for which ICE performs accounting services, combined with the Coast Guard, represent approximately 15.1 percent of total assets, and \$15.4 billion or 14.4 percent of the total DHS fiscal year 2005 budget authority.

Conditions: The conditions described below are structural in nature, and rise to the level of a material weakness because they affect the overall integrity of DHS’ consolidated financial statement reporting process and its ability to comply with laws and regulations.

1. ICE has not made sufficient, measurable progress in correcting its financial management oversight and weaknesses. All of the conditions we reported last year are repeated together with new findings. Financial management at ICE has been ineffective. We noted that ICE:
 - Did not have sufficient numbers of qualified financial managers and staff to perform its accounting responsibilities. Despite the hiring of a new acting CFO and a new financial director, ICE relied on OCFO assistance and outside contractors to diagnose problems, make management decisions, and provide routine accounting staff supervision. ICE continued to fall seriously behind in performing accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting, which prevented it from submitting timely and accurate periodic financial reports to the OCFO during fiscal year 2005. Specifically, during fiscal year 2005, ICE financial managers and staff were unable to:
 - Perform analysis of and record basic and routine accounting entries;
 - Correctly apply Federal accounting standards, in many instances, to ensure accurate and reliable financial reporting;

Independent Auditors' Report**Appendix I – Material Weaknesses in Internal Control**

- Develop and communicate accounting policies and procedures throughout ICE and the DHS-ICE components it serviced to ensure accuracy and consistency in financial reporting;
 - Timely and accurately respond to data requests from the OCFO during the year; and
 - Establish adequate internal controls that reasonably ensured the integrity of financial data, and that adhered to Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government (Standards)*.
- Lacked a comprehensive strategy to identify the root causes of its financial statement errors and to correct deficiencies in its accounting and financial reporting processes. As a result, pervasive, and potentially systemic, financial statement errors and abnormal balances existed, in both proprietary and budgetary accounts, throughout fiscal year 2005.
 - In conjunction with the DHS-ICE components, ICE continued to operate unreliable processes and procedures that support accounting and financial reporting; resulting in material errors, irregularities, and abnormal balances in the DHS consolidated financial statements that existed for most of fiscal year 2004 and continued unresolved in fiscal year 2005.
 - Continued to execute responsibilities for certain administrative / accounting functions for other DHS components without proper reimbursable agreements to cover these costs, well into the fiscal year.
 - Was unable to quantify and record correcting adjustments to restate the fiscal year 2004 financial statements for known errors.
2. The Coast Guard:
- Has not fully implemented a financial management organizational structure that supports the development and implementation of effective policies, procedures, and internal controls to ensure data supporting financial statement assertions are complete and accurate.
 - Has not established clear management oversight responsibilities and processes to review adjustments to account balances, identify the cause of abnormal balances, and account relationship discrepancies, e.g., budgetary to proprietary reconciliations, and investigate potential financial system concerns such as potential posting logic errors.
 - Has not fully established management oversight functions to ensure that accounting principles are correctly applied, and to provide accounting operational guidance to other offices and facilities within the Coast Guard.
3. The OCFO has not:
- Completed its plan to expand the OCFO with sufficient resources, including personnel with the requisite experience and skills to effectively manage the financial reporting and internal control infrastructure of a large Executive Branch agency.
 - Provided effective management and oversight to ensure that:
 - DHS component corrective action plans were developed, implemented, with progress tracked, and successfully completed, particularly at ICE and the Coast Guard, to support the elimination of material weaknesses and achieve consistent, timely, and reliable

Independent Auditors' Report

Appendix I – Material Weaknesses in Internal Control

- financial reporting from all DHS components, within the time-period requested by the Secretary;
- Financial management, and reporting problems in DHS components were promptly and effectively addressed;
 - Workload among OCFO staff was separated to allow for proper supervisory reviews, and to provide appropriate back-up for key staff; and
 - Processes were implemented to draft an accurate and complete DHS *Performance and Accountability Report* (PAR), within a reasonable time-frame after year-end, and to prepare accurate monthly financial statements throughout the year, that did not require restatements to previously published financial statements, as discussed further in Comment B – *Financial Reporting*.

The organizational weaknesses detailed above have led to specific conditions that affect the quality of financial reporting at DHS, and are further described in Comment B - *Financial Reporting*.

Cause/Effect: DHS has attempted the stand-up of a large, new, and complex Executive Branch agency, without the assistance of sufficient organizational and accounting expertise. Since its inception in 2003, the Department has not made sufficient investments in human capital and other critical infrastructure necessary for reliable financial processes. The Department CFO's ability to fully address these weaknesses has been significantly impaired by the financial management structure and the need to provide significant oversight at ICE and the Coast Guard. The severity of the conditions at ICE and the Coast Guard caused the CFO of both components to issue statements of "no assurance" on internal control over financial reporting. Due to the significance of the balance sheet accounts at ICE and the Coast Guard to DHS' consolidated balance sheet, the DHS Secretary and CFO were also unable to render assurances on the effectiveness of internal controls over financial reporting in fiscal year 2005.

The human resources, financial systems, processes, and control activities at ICE which also supported the DHS-ICE components were inadequate to process financial transactions for components of their size.

The Coast Guard has made progress in hiring qualified personnel and has developed a corrective action plan; however, management has acknowledged that longstanding procedural, control, personnel, and cultural issues have impeded progress toward installing an effective financial management structure. In addition, the Coast Guard's CFO must coordinate with heads of various divisions who have a role in the accounting and financial reporting processes, but who otherwise have limited exposure to financial statement audits. Further, these division heads change regularly as part of the Coast Guard military assignment and rotation policies, making it difficult for the CFO to institutionalize internal controls related to financial management and reporting that are outside the CFO's direct organization.

As a result, the conditions described above continue to prevent DHS from timely preparation of accurate financial information and reports, and have contributed to the conditions reported in Comment B – *Financial Reporting* of this Appendix. Lack of adequate processes, and sufficient experienced staff or contractors, has led management to place excessive reliance on the financial statement audit to identify errors in accounts and deficiencies in processes and controls. DHS will continue to have difficulty complying with Federal accounting standards and requirements, and implementing appropriate internal control as defined by the Comptroller General, until adequate processes and skilled management and staff resources are engaged at ICE, the Coast Guard and within the OCFO.

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Criteria: The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards*. The GAO defines internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Further, the GAO *Standards* identify five standards to be implemented: control environment, risk assessment, control activities, information and communication, and monitoring. These standards cover controls such as human capital practices, supervisory reviews, and segregation of duties, policies, procedures, and monitoring.

Recommendations: We recommend that

1. ICE:

- a) Perform a detailed capabilities assessment of financial personnel at ICE headquarters, the Dallas Finance Center, and the Debt Management Center, to identify critical skill-level gaps and develop and execute a hiring strategy to fill the gaps. In the short-run, solicit assistance from the Office of Management and Budget (OMB) or other Federal agencies by requesting temporary transfers of experienced management and accounting personnel. To be successful with this initiative, an experienced project manager must be identified, and the full support of the DHS Secretary, OCFO and ICE Assistant Secretary will be needed – including, if necessary, an emphasis in the ICE mission statement on reliable financial management and reporting objectives; and
- b) Critically assess the current accounting systems and processes, especially those with serious material weaknesses. Develop a financial reporting risk profile to assist management with ranking and prioritization of financial accounting, and reporting structural deficiencies. Develop a detailed financial accounting and reporting architecture of necessary systems, policies, processes, procedures, and internal controls; and finally implement corrective action plans to achieve the desired end-state of reliable and timely financial reporting.

2. Coast Guard:

- a) Evaluate the existing financial management organizational and internal control structure and conduct an assessment to determine the number of personnel and resources needed, along with the requisite skills and abilities necessary to provide effective guidance, and oversight to program offices that are significant to financial management and reporting, and make recommendations to senior management for appropriate changes. Consider the establishment of an Office of Financial Management that would have the authority, ability and appropriate resources to oversee all Coast Guard financial management policy, systems and reporting;
- b) Establish internal controls and related procedures for performing periodic reviews and oversight to assess the appropriateness, to include compliance with generally accepted accounting principles, of financial policies and procedures, and the design and operating effectiveness of internal controls. Consider prioritizing remediation of material weaknesses given the available resources;
- c) Establish clear management oversight responsibilities and processes to effectively review adjustments to account balances, identify the cause of abnormal balances and account for relationship discrepancies, e.g., budgetary to proprietary reconciliations, and investigate potential financial system concerns such as potential posting logic errors; and

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- d) Consider establishing a process to benchmark Coast Guard financial management and oversight to other agencies that have been recognized for excellence in financial management, and have an established track record of unqualified opinions on their audited financial statements.
3. The OCFO:
- a) In coordination with its independent auditor, consultants, and the Office of Inspector General, perform a gap analysis of the resource weaknesses, including personnel skill sets, and develop and implement a strategic plan to address those gaps and financial reporting and internal control weaknesses in the OCFO and throughout the Department;
 - b) Continue to supplement its accounting staff with personnel with skill-sets that compliment the current staff and result in a stronger Department-wide control environment;
 - c) Obtain and use authority from the Secretary's office to require DHS components to develop and implement sound, reasonable, appropriately funded, corrective action plans that will eliminate material weaknesses and result in timely, accurate financial reporting. This initiative will likely require assistance from the Secretary's office to emphasize the necessity of good financial management, hold components and departmental management accountable for progress, and in some cases will require substantial cultural shifts and a commitment of resources; and
 - d) Continue to implement processes and controls within the OCFO that will support the timely and accurate completion of the Department's interim financial reports and year-end PAR.

B. Financial Reporting

Background: Financial reporting at DHS is dependent upon the quality of financial reporting at its individual components, and the ability of the OCFO to consolidate information timely and consistently. Under the current financial reporting structure, the OCFO prepares consolidated financial statements, including footnote and supplementary data, from trial balances and other financial data submitted by the components to the OCFO, and submits data to the Treasury Information Executive Repository (TIER) system. The OCFO is also responsible for development and communication of appropriate accounting policies, ensuring that financial reporting controls exist, and performing certain quality control procedures to monitor financial information. The components are not required to prepare complete financial statements with footnotes and supplementary data that comply with generally accepted accounting principles. The vast majority of DHS' financial reporting resources have remained decentralized at the component level.

Conditions: We noted the following internal control weaknesses related to financial reporting in the OCFO and DHS components:

1. The OCFO:
- Was unable to prepare a balanced¹ consolidated financial statement during fiscal year 2005 until November 2005. In addition, the consolidated financial statement disclosures and notes

¹ Balanced in this context means: assets equal liabilities plus net position, on a consolidated basis, as presented on the balance sheet.

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contained critical errors and inconsistencies, when provided to us less than two weeks before the filing deadline of November 15, and required material adjustments to correct.

- Has not fully documented policies and procedures for many critical activities necessary to adequately manage financial reporting processes, such as policies and procedures related to a year-end or interim close schedule to prepare reliable consolidated financial statements, comprehensive requirements for resolving intradepartmental and intragovernmental elimination discrepancies, and making changes to the PAR guidance disseminated to the DHS components.
- Has not implemented sufficient procedures and monitoring controls to ensure monthly TIER submissions received from the components were prepared timely and accurately, including adequate supporting documentation for elimination entries and adjustments at the consolidated financial statement level necessary to prepare consolidated financial statements.
- Has implemented policies and procedures, but has not required the components to follow the policies and procedures and effectively use recently installed TIER analytical tools to improve the integrity and reliability of financial data at the components, and as a result, the component TIER submissions contained numerous abnormal balances and potential errors that were not explained in a timely manner. In addition, some OCFO personnel accepted explanations from components for financial statement abnormalities that were incomplete and inaccurate, and did not include sufficient detail to inform the reviewer of the nature of the error and when the condition would be corrected.
- Omitted two financial statement note disclosures required by OMB Circular No. A-136, *Financial Reporting Requirements, Part A, Form and Content of the Performance and Accountability Report*, which were:
 - A reconciliation of the Department's fiscal year 2004 budget amounts, as presented in the statement of budgetary resources to the President's budget; and
 - Intra-agency eliminations necessary to prepare the statement of net cost by sub-organization major programs.

2. At Coast Guard:

- The financial reporting process was complex and labor-intensive, and required a significant number of "on-top" adjustments (adjustments made outside the core accounting system for presentation of financial information given to DHS for consolidation). A significant amount of manual review was required to integrate data from three separate general ledger systems and overcome system and process deficiencies. One of the most significant deficiencies was that the Coast Guard produced its TIER submission from a database that did not have detail at the transactional level, and that did not agree to the transactional balances in the Coast Guard's general ledgers.
- Significant abnormal balances existed in its TIER submissions, but the Coast Guard only had limited procedures for identifying and resolving those abnormal balances, and potential errors at a transaction level. As a result, the Coast Guard made routine "top-side" adjustments to prepare its monthly TIER submission to the OCFO that, in some cases, might have masked potential errors that instead should have been researched.

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- The Coast Guard routinely used analytical comparisons to identify adjusting entries to the financial statements, without verifying that the ending balances were properly supported at the transaction level, e.g., budgetary accounts were adjusted to equal proprietary accounts, without verifying that the underlying transactional detail supported the ending balances.
 - The processes that Finance Center personnel used for making year-end closing entries did not consistently include sufficient supporting documentation or internal controls at an appropriate level, such as effective management review, approval of individual adjusting entries, or procedures to determine that all necessary adjustments were identified.
 - The processes used for some account reconciliations were not well designed. For example, procedures for reconciling cumulative results of operations, and resolving inconsistencies in the accounting treatment for inter-entity balances were weak and in many cases lacked documentation.
 - Personnel did not effectively complete the GAO Disclosure Checklist for the September 30, 2005 DHS financial statements.
3. ICE has not:
- Established effective internal controls over the daily accounting and recording of transactions, supervisory review, reconciliation of accounts, and documentation of supporting information for auditor review. ICE routinely made “top-side” adjustments to financial information that was not adequately reviewed, supported by transactional data, or documented. For example, we noted that personnel often approved adjusting general ledger entries for which they did not have a thorough knowledge or understanding, and adequate supporting documentation for the adjusting journal entries was not maintained.
 - Reconciled quarterly *Report on Budget Execution* (SF-133)s to approved *Apportionment and Reapportionment Schedule* (SF-132)s for all Treasury Appropriation Fund Symbol (TAFS) accounts. At September 30, 2005, we noted differences in the amounts reported in FFMS (the core accounting system) and some SF-133s and SF-132s, totaling more than \$550 million across ICE and DHS-ICE components that could indicate a potential violation of the *Antideficiency Act*.
 - Adequately designed the processes to be used for some account reconciliations. For example, procedures for reconciling cumulative results of operations, and resolving inconsistencies in the accounting treatment for inter-entity balances were weak and in many cases lacked documentation.
 - Provided guidance to DHS-ICE components regarding how to process financial transactions timely and accurately, and did not have documented policies and procedures that will ensure that financial information submitted monthly to the OCFO is in compliance with generally accepted accounting principles.
 - Adhered to the schedule set by the OCFO, to submit accurate monthly TIER reports and other accompanying information, complete the GAO checklist, and provide other information needed by the OCFO to prepare the fiscal year 2005 PAR. For example, we noted that ICE was unable to file an accurate TIER submission without DHS CFO waivers of significant error conditions for every month we reviewed (seven in total), and was unable to perform an effective hard-close at June 30, 2005, as requested by the DHS CFO.

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- Successfully integrated the Federal Protective Service (FPS) accounting processes from the General Service Administration (GSA) to ICE, creating numerous issues with the integrity of FPS transaction data.
4. The Transportation Security Administration (TSA) experienced difficulties in the monthly closing of its general ledger due, in part, to its change in accounting services providers. Specifically, we noted accrual amounts were not included in the initial financial data submission for year-end, numerous other on-top adjustments were made thereafter, account reconciliations were not performed timely throughout the year, material abnormal balances and analytical account variances were not resolved timely throughout the year, and detailed schedules to support financial statement amounts were not always provided timely.
 5. The Coast Guard and ICE did not have effective financial information systems, or sufficiently documented processes, to accumulate cost data by DHS strategic goal, as required by Statement of Financial Accounting Standard (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards*. In addition, TSA and Emergency Preparedness and Response (EPR) did not have documentation to support their presentation of the full cost for each strategic goal, as included in the notes to the consolidated financial statements.
 6. Office of State and Local Government Coordination and Preparedness (SLGCP) has not obtained a thorough understanding of control activities over the financial reporting processes performed by its accounting service provider on its behalf, to ensure services received are consistent with the intent of the parties. The financial statement impact of this condition is further explained in Comment G – *Undelivered Orders, Accounts and Grants Payable, and Disbursements*, in this appendix.
 7. EPR's contractor for the National Flood Insurance Program (NFIP) did not provide final NFIP financial statements until November 8, 2005, after the time that final EPR fiscal year 2005 financial statement balances had been submitted to the OCFO. The NFIP financial statements reported an accounts payable balance that was approximately \$3 billion lower than the estimate provided to the OCFO, and consequently DHS was required to record a late adjustment in the consolidated financial statements to true-up the final balances. Without timely receipt of the NFIP financial statements, EPR is unable to make an accurate estimate of accounts payable related to the NFIP. In addition, the required timing of the contractor's Statement of Auditing Standards No. (SAS 70) *Service Organizations*, review report has not been modified based on accelerated financial statement reporting deadlines for the Federal government

Cause/Effect: Many of the issues mentioned above stem from the conditions described in Comment A - *Financial Management and Oversight*. The OCFO is still working to develop effective and consistent financial policies and procedures that will ensure a smooth and reliable month-end close for all components. Financial data received from the components during fiscal year 2005 often contained large abnormal or unusual balances that were not timely reviewed and cleared. The lack of quality financial data received from the components placed a heavy burden on the OCFO to identify the issues, reconcile accounts, engage the components in researching the issues, and eventually work with the components to record correcting entries – before accurate consolidated financial statements could be prepared. The OCFO is not staffed to perform these functions on a regular basis. As described above, some components have not developed adequate policies and procedures to perform a reliable monthly close, and accurately export data from their general ledgers for periodic TIER submissions.

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At the Coast Guard, the accuracy of financial information is highly dependent on the knowledge and experience of a limited number of key financial personnel rather than on clearly documented procedures manuals, and process flow documentation. In addition, the Coast Guard suffers from system deficiencies that make the financial reporting process more complex and difficult. ICE has been unable to successfully complete the integration of the accounting processes of the five DHS components for which it became responsible in fiscal year 2004. A financial accounting system conversion at TSA, during fiscal year 2005, contributed to its reporting problems, and caused errors and delays in DHS financial reporting.

SLGCP places a significant amount of reliance on its accounting services provider, an entity outside DHS, to process and report its transactions because it lacks resources to perform effective oversight of the financial reporting process, and related control activities performed on its behalf. As a result, SLGCP lacks assurance that the processing of its financial activities coincides with its business operations, and are accurately reported and properly controlled.

Companies participating in the NFIP are required to submit their NFIP-related financial statements to EPR's contractor each month within 21 days of the month end. The contractor combines these financial statements with the financial information for the NFIP's administrative activities, and then submits final NFIP financial statements to EPR for recording in EPR's general ledger. However, the process of compiling the information into the final NFIP financial statements can be an extended process, because it takes time for the information to be received from the NFIP participants and then for that information to be properly processed and reported.

Criteria: FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards*. These standards define internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The GAO *Standards* require that internal controls be documented in management directives, administrative policies, or operating manuals; transactions and other significant events be clearly documented; and information be recorded and communicated timely with those who need it within a timeframe that enables them to carry out their internal control procedures and other responsibilities. According to these standards, the five essential control elements are: control environment, risk assessment, control activities, information and communication, and monitoring.

Recommendations: We recommend that:

1. The OCFO:
 - a) Implement a standardized financial reporting process, including formal policies and procedures that require components to prepare financial reporting closing packages with footnotes and supplementary data that comply with generally accepted accounting principles to assist the components and the OCFO to execute a monthly close that results in complete and reliable financial reporting on an interim basis, and at year end. The interim hard close and year-end process should include procedures to prepare financial statement notes, Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), Required Supplementary Information (RSI), and performance data that are in full compliance with generally accepted accounting principles, and OMB Circular No. A-136. The OCFO should perform several "test runs" during fiscal year 2006, e.g., each quarter, to critically evaluate and improve the process as necessary;

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- b) Assist the components with an assessment to determine the reasons for TIER reporting delays and provide management oversight to correct weaknesses;
 - c) Maintain supporting documentation for all elimination and other adjusting entries made at the consolidated financial statement level; and
 - d) Establish procedures that will improve the effectiveness of monitoring controls over financial data to ensure that abnormal balances and potential errors submitted by the components are resolved monthly.
2. Coast Guard:
- a) Conduct an assessment of its current financial reporting process, including a review of its three general ledger systems, with the goal of reducing complexity, implementing appropriate internal controls, improving financial systems integration and automating manual processes. Processes should be designed to ensure that all financial statement line items are fully supported by transactional detail contained in the general and subsidiary ledgers, and causative research performed for imbalances and abnormalities. The timely reconciliation of all account balances to transactional detail should be documented and retained for auditor review throughout the year;
 - b) Improve documentation for year-end closing entries, including effective management review and approval, and clear identification of all on-top adjustments with all associated general ledger account entries;
 - c) Analyze and, as appropriate, redesign its processes for account reconciliations; and
 - d) Implement policies and procedures to fully identify and resolve significant abnormal balances at a transaction level before the monthly TIER is submitted to the OCFO.
3. ICE:
- a) Establish effective internal controls over the daily accounting, recording, reconciliation and documentation of transactions. Supervisory reviews should be performed by persons with sufficient knowledge to be an effective control, i.e., to discover an error through review. Specific procedures and controls should be implemented over “top-side” adjustments made to financial information because these transactions are more prone to error;
 - b) Reconcile its SF-133s to approved SF-132s on a quarterly basis, and research and resolve the discrepancies that existed at September 30, 2005, and report any violations of the *Antideficiency Act*;
 - c) Analyze and, as appropriate, redesign its processes for account reconciliation;
 - d) In conjunction with the DHS CFO, implement policies, procedures, and guidance that fully describe how operating offices and DHS-ICE component entities are required to process accounting transactions. When complete, the redesigned processes should result in timely and accurate financial information submitted monthly to the OCFO that is in compliance with generally accepted accounting principles;
 - e) Establish and maintain routine communication channels with the DHS OCFO to assist in meeting deliverable deadlines; and
 - f) Continue efforts to resolve all issues arising from the integration of FPS accounting processes from GSA to ICE.

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4. TSA:
 - a) Conduct an assessment of the monthly closing process to identify and correct weaknesses that impede timely and efficient reporting processes; reduce the number of on-top adjustments; and perform regular quality control reviews of financial reports; and
 - b) Document key standard operating procedures (SOPs) for significant financial reporting processes, including the TIER submissions.
5. The Coast Guard and ICE should develop financial information systems and document processes to accumulate and present cost data by DHS strategic goal, as required by SFFAS No. 4. Additionally, TSA and EPR should develop a process to validate, document and report the full cost of each strategic goal, as presented in the notes to the DHS consolidated financial statements, so that the computations and presentation in the financial statements are consistent with generally accepted accounting principles.
6. SLGCP:
 - a) Designate an official to perform a financial oversight role, and take responsibility for monitoring the financial processing and reporting activities performed by its accounting services provider. This official should obtain appropriate assurances from the accounting services provider (e.g., through a SAS 70 review report) to be able to assess that controls relevant to SLGCP's financial activities are properly designed and operating effectively; and
 - b) Work with DHS management to migrate SLGCP's general ledger and grants management system to a system maintained by a component within DHS.
7. EPR should coordinate with its NFIP contractor, and modify its existing contract with the company, if necessary, to ensure that (a) the contractor can provide final year-end NFIP financial statements to EPR for inclusion in EPR's final TIER submission, and (b) the contractor's annual SAS 70 report covers at least nine months of DHS' fiscal year and is available in final form no later than September 1, each year.

C. Financial Systems Security

Background: Controls over information technology (IT) and related financial systems are essential elements of financial reporting integrity. Effective general controls in an IT and financial systems environment are typically defined in six key control areas: entity-wide security program planning and management, access control, application software development and change control, system software, segregation of duties, and service continuity. In addition to general controls, financial systems contain application controls which are the structure, policies, and procedures that apply to separate, individual application systems, such as accounts payable, inventory, payroll, grants, or loans.

During fiscal year 2005, DHS took several actions to improve its IT general control environment, and to address many prior year general IT control issues. For example, DHS issued an update to DHS Policy 4300A, *Sensitive System Handbook*. The purpose of this Handbook update was to provide specific techniques and procedures for implementing the requirements of DHS' *IT Security Program for Sensitive Systems*. These actions resulted in the correction of some conditions we reported in 2004. Despite these improvements, several significant general IT and application control weaknesses remain that collectively limit DHS' ability to ensure that critical financial and operational data is maintained in a manner to ensure confidentiality, integrity, and availability.

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Conditions: In fiscal year 2005, the following IT and financial system control weaknesses were identified at DHS and its components. Most of the technical issues identified during our fiscal year 2005 audit were also identified during fiscal year 2004:

1. Entity-wide security program planning and management – we noted:
 - Despite improvements in the process of performing Certification and Accreditation (C&A) of IT systems, five DHS component financial and associated feeder systems were not properly certified and accredited.
 - Instances of fragmented, incomplete, or missing security policies and procedures relating to the hiring and termination of employees, reviewing of access to key financial systems, computer incident response capabilities, and interconnectivity agreements exist.
2. Access controls – we noted:
 - Instances of missing and weak user passwords on key servers and databases.
 - User account lists were not periodically reviewed for appropriateness, and inappropriate authorizations and excessive access privileges for group user accounts were allowed.
 - Instances where workstations, servers, or network devices were configured without necessary security patches, or were not configured in the most secure manner.
 - Application and operating system settings were not configured for automatic log-off or account lockout.
3. Application software development and change control – we noted:
 - Instances where policies and procedures regarding configuration management controls were not in place to prevent users from having concurrent access to the development, test, and production environments of the system.
 - Changes made to the configuration of the system were not always documented through System Change Requests (SCRs), test plans, test results, or software modifications. Additionally, documented approval did not exist, or was not always retained, for emergency enhancements, “bug” fixes, and data fixes, and in some cases, audit logs for tracking changes to the data or systems were not activated.
4. System software – we noted:
 - Instances where policies and procedures for restricting and monitoring access to operating system software were not implemented or were inadequate. In some cases, the ability to monitor security logs did not exist.
 - Changes to sensitive operating system settings and other sensitive utility software and hardware were not always documented.
5. Segregation of duties – we noted:
 - Instances where individuals were able to perform incompatible functions, such as the changing, testing, and implementing of software, without sufficient compensating controls in place.
 - Instances where key security positions were not defined or assigned, and descriptions of positions were not documented or updated.

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6. Service continuity – we noted:

- Five DHS components had incomplete or outdated business continuity plans and systems with incomplete or outdated disaster recovery plans. Some plans did not contain current system information, emergency processing priorities, procedures for backup and storage, or other critical information.
- Five DHS component's service continuity plans were not consistently and/or adequately tested, and individuals did not receive training on how to respond to emergency situations.

7. Application controls – we noted:

- Several instances of weak access and segregation of duty controls associated with key DHS financial applications, such as a DHS component's core financial application, as well as procurement and payable applications. These weaknesses include weak or expired user passwords, user accounts that were not kept current, and certain users with access privileges to certain key processes of an application. Many of these weaknesses were identified during our general control testing of access controls and segregation of duties; however, since these same issues also impact controls over specific key financial applications, they are reported here as well.

Cause/Effect: Many of these weaknesses were inherited from the legacy agencies that came into DHS, and will take several years to fully address. Management has undertaken a complicated task of merging numerous and varying financial management systems and control environments into a DHS environment. At many of the larger components, IT and financial system support operations are decentralized, contributing to challenges in integrating DHS IT and financial operations. In addition, financial system functionality weaknesses, as discussed throughout our report on internal controls, in various processes, can be attributed to non-integrated legacy financial systems that do not have the embedded functionality called for by OMB Circular No. A-127, *Financial Management Systems*. Further, there is no consistent testing and monitoring of IT controls by individual DHS components and by the DHS-CIO to identify and mitigate weaknesses.

Criteria: The *Federal Information Security Management Act (FISMA)*, passed as part of the *Electronic Government Act of 2002*, mandates that Federal entities maintain IT security programs in accordance with OMB and National Institute of Standards and Technology (NIST) guidance. OMB Circular No. A-130, *Management of Federal Information Resources*, and various NIST guidelines describe specific essential criteria for maintaining effective general IT controls. In addition, OMB Circular No. A-127 prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems.

Recommendations: We recommend that the DHS Office of Chief Information Officer in coordination with the OCFO:

1. For entity-wide security program planning and management:

- a) Enforce a DHS C&A program across all DHS components, which should include an emphasis on a consistent and thorough approach to the testing of key technical controls during the certification process; and
- b) Enforce the consistent implementation of security programs, policies, and procedures.

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2. For access control:
 - a) Enforce password controls that meet DHS password requirements on all key financial systems;
 - b) Implement an account management certification process within all the components, to ensure the periodic review of user accounts for appropriate access;
 - c) Implement a DHS-wide patch and security configuration process, and enforce the requirement that systems are periodically tested by individual DHS components and the DHS-CIO; and
 - d) Conduct periodic vulnerability assessments, whereby systems are periodically reviewed for access controls not in compliance with DHS and Federal guidance.
3. For application software development and change control:
 - a) Develop policies and procedures regarding configuration management controls, and implement to ensure segregation of change control duties; and
 - b) Enforce policies that require changes to the configuration of the system are approved and documented, and audit logs are activated and reviewed on a periodic basis.
4. For system software, actively monitor the use, and changes related to operating systems, and other sensitive utility software and hardware.
5. For segregation of duties:
 - a) Document the user responsibilities so that incompatible duties are consistently separated. If this is not feasible given the smaller size of certain functions, then sufficient compensating controls, such as periodic peer reviews, should be implemented; and
 - b) Assign key security positions, and ensure that position descriptions are kept current.
6. For service continuity:
 - a) Develop and implement complete current business continuity plans, and system disaster recovery plans; and
 - b) Perform component-specific and DHS-wide testing of key service continuity capabilities, and assess the need to provide appropriate and timely emergency training.
7. For application controls:
 - a) Implement policies to ensure that password controls meet DHS password requirements on all key financial applications and feeder systems;
 - b) Implement an account management certification process within all the components, to ensure the periodic review of user accounts for appropriate access; and
 - c) Document the user responsibilities so that incompatible duties are consistently separated. If this is not feasible given the smaller size of certain functions, then sufficient compensating controls, such as periodic peer reviews, should be implemented.

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D. Fund Balance with Treasury

Background: Fund Balance with Treasury (FBWT) represents accounts held at Treasury from which an agency can make disbursements to pay for its operations. Regular reconciliation of an agency's FBWT records with Treasury is essential to monitoring and safeguarding these funds, improving the integrity of various U.S. Government financial reports, and providing a more accurate measurement of budget resources and status. FBWT at ICE, and the other DHS-ICE components it services, and at the Coast Guard totaled approximately \$9.2 billion or 9.5 percent of total DHS assets at September 30, 2005. The majority of these funds represented appropriated amounts that were obligated but not yet disbursed at September 30, 2005.

Conditions: We noted the following internal control weaknesses related to FBWT, many of which are repeated from fiscal 2004:

1. ICE:

- Did not complete accurate and timely reconciliations of all of its FBWT accounts during the year, as required by the Treasury Financial Manual (TFM). ICE assumes Treasury balances are correct and often makes adjustments to force its balances to equal Treasury. Specifically, ICE did not perform procedures to reconcile FBWT to Treasury forms FMS 6652, *Statement of Differences*; FMS 6653/54 *Undisbursed Appropriation Account Ledger/Trial Balance*; SF 224 *Statement of Transactions*; and/or FMS 6655 *Receipt Account Ledger/Trial Balance* in accordance with TFM 5145. In addition, ICE did not maintain documentation supporting the reconciliation processes as required by TFM 2-5100.
- Did not timely clear items carried in suspense clearing accounts during the year. A significant number of transactions were carried in suspense, some of which were more than six months old and related to fiscal year 2004 transactions, totaling over \$100 million dollars in unreconciled balances. In addition, the subsidiary ledger that contained detail listings of suspense transactions was not reconciled to the general ledger.
- Did not accurately clear suspense transactions to the proper obligation or other Standard General Ledger (SGL) account, particularly for Intra-Governmental Payment and Collection (IPAC) transactions from other Federal agencies, and for disbursements made by legacy agencies on behalf of itself and DHS-ICE components.
- Lacked written policies that clearly explain the correct reconciliation processes and internal controls that must be performed to ensure that monthly collection and disbursement activity is reported accurately and timely to the Treasury, and reflected in ICE and DHS-ICE components' general ledgers.
- Was unable to obtain document level information for financial transactions (both procurement and disbursement) of the DHS-ICE components that were processed by legacy agencies, which resulted in large, unreconciled FBWT items.

2. Coast Guard:

- Did not effectively manage its suspense accounts to include accurately aging and clearing items carried in suspense clearing accounts in a timely manner during the year. From a sample of 45 suspense transactions, we identified 5 transactions that were posted to an inappropriate obligating document, and 3 sample items that had activity dates in fiscal years 2001 and 2002.

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- Did not maintain adequate supporting documentation that validated the accuracy of the FBWT reconciliations and the clearing of suspense items.

Cause/Effect: The procedures followed by ICE placed inappropriate reliance on the Treasury's records for the status of funds, resulting in incomplete monthly reconciliations. These conditions have existed at ICE for several years, in part because of inadequate management oversight and direction, as discussed in Comment A, above. ICE and Coast Guard did not maintain sufficiently detailed records to clear suspense accounts in a timely manner, and did not use tools available to them to improve the process, such as the *Government-wide Accounting System* (GWA). Failure to implement timely and effective reconciliation processes could increase the risks of fraud, abuse, undetected violations of appropriation laws, including instances of undiscovered *Antideficiency Act* violations, and mismanagement of funds, which leads to inaccurate financial reporting, and affects DHS' ability to effectively monitor its budget status.

Criteria: The TFM² states, "Federal agencies must reconcile their SGL account No.1010, and any related sub-accounts, with the FMS 6652, 6653, 6654 and 6655 on a monthly basis (at minimum). They must review those accounts each month to maintain the accuracy and reliability of their fund balance records for both prior year and current year appropriations. Agencies must reconcile no-year, revolving, deposit, and trust fund accounts. They also must reconcile clearing and receipt accounts. This detailed reconciliation assures that agency data accumulated in the fund balance account is accurate. It also allows the agency to resolve differences in a timely manner. Federal agencies must research and resolve differences reported on the monthly FMS 6652. They also must resolve all differences between the balances reported on their general ledger FBWT accounts, and balances reported on the FMS 6653, 6654 and 6655. When resolving differences, agencies should maintain detailed reconciliation worksheets that, if needed, can be reviewed by the Agency's auditors or Treasury." TFM Section 5145, *Reconciling Budget Clearing Account Differences*, states, "Agencies must reconcile all Budget Clearing Account Balances, including F3875 accounts. They must reclassify these balances to appropriate Treasury account symbols." TFM Section 5125 – *Background*, specifies the procedures to be performed when reconciling FBWT.

OMB Circular No. A-123, *Management Accountability and Control*, states that transactions should be promptly recorded, and properly classified and accounted for in order to prepare timely, and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

Recommendations: We recommend that:

1. ICE:
 - a) Perform all procedures required by the TFM, including sections 5125, 5145 and Supplement I of TFM 2-5100 and maintain supporting documentation;
 - b) Develop accurate and complete procedures to reconcile and clear FMS 6652 items for its Agency Location Codes (ALCs) on a monthly basis, and provide proper training to employees;
 - c) Develop and implement written policies that require timely and accurate reconciliation, and clearing of suspense balances to the proper SGL account, and retention of adequate supporting documentation that facilitate supervisory review, and other monitoring controls. Typically, significant balances should not be held in suspense more than 30 days; and

² TFM, Supplement I TFM 2-5100 (November 1999)

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- d) In conjunction with the DHS OCFO, develop policies and procedures for obtaining relevant legacy agency processed transactions in order to timely record all transactions affecting FBWT.
2. Coast Guard implement written policies, including detailed procedures that result in timely reconciliation of FBWT in accordance with the TFM, timely and accurate clearing of suspense balances, and the retention of adequate supporting documentation that will facilitate supervisory review and other monitoring controls. The policies should be based on Treasury guidance and tailored to the Coast Guard's operations and financial accounting system(s).

E. Property, Plant, and Equipment

Background: Property, plant, and equipment (PP&E) represents approximately 9.1 percent of total DHS assets and more than 62.6 percent of non-monetary assets. DHS uses a wide variety of capital assets to accomplish its mission, some of which are not typically maintained by non-defense agencies, such as aircraft, boats, and vessels. These assets often have long useful lives and undergo extensive routine servicing that may increase their value or extend their useful lives and require comprehensive policies and procedures to ensure accurate and timely accounting. While the Coast Guard has made progress in providing auditable documentation for certain categories of PP&E, most of the conditions cited below for the Coast Guard are repeated from our fiscal year 2004 report, because the Coast Guard has not fully completed its corrective action plans. In addition, as noted in our 2004 report, DHS has several internal use software development projects underway that will result in capitalized software balances in future years. Consequently, application of proper accounting standards to account for PP&E is important to the accuracy of DHS' consolidated financial statements.

Conditions: We noted the following internal control weaknesses related to PP&E at DHS components, which are mostly repeated from fiscal year 2004:

1. Coast Guard has not:
 - Implemented appropriate controls and related processes to accurately, consistently, and timely record PP&E, to include additions, transfers from other agencies, and disposals in its fixed asset system.
 - Consistently applied policies and procedures to ensure appropriate documentation supporting PP&E acquisitions is maintained, and readily available for audit. The acquisition values of approximately twenty five percent of items selected for testwork did not have proper supporting documentation.
 - Developed and documented methodologies and assumptions to support the value of PP&E that is not supported by original acquisition or other documentation.
 - Implemented asset identification, system mapping, and tagging processes that include sufficient detail, e.g., serial number, to clearly differentiate and accurately track assets in the fixed asset system.
 - Developed an effective physical inventory process and appropriate support for the valuation method and classification of repairable PP&E.
 - Properly accounted for some improvements and impairments to buildings and structures, and selected useful lives for depreciation purposes, consistent with generally accepted accounting principles.

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2. ICE (who provides accounting services for BTS), specifically the US-VISIT program, did not consistently apply procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development. At September 30, 2005, software costs were not considered material to the consolidated financial statements; however, software development costs are expected to increase in future years.

Cause/Effect: Coast Guard has implemented policies and procedures affecting PP&E; however, they are not comprehensive and; therefore, do not provide reasonable assurance that all transactions affecting PP&E will be accounted for consistent with generally accepted accounting principles. In addition, the fixed asset module of the Coast Guard's core accounting system is not updated for effective tracking of all PP&E, and its capabilities are not fully utilized to clearly differentiate and accurately track assets. The Coast Guard also lacks sufficient policies and procedures for PP&E that ensure complete supporting documentation is maintained and available for audit. As such, we were unable to complete audit procedures over approximately \$1.7 billion of net PP&E as of September 30, 2005.

BTS lacks sufficient accounting policies for software development costs. Over the next few years, significant resources for the development of new software, such as the US-VISIT system, will likely be spent. Therefore, the lack of sufficient policies at BTS increases the risk of financial statement errors due to misapplication of accounting standards for software.

Criteria: SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, requires that:

- PP&E be recorded at historical cost with an adjustment recorded for depreciation. In the absence of such information, estimates may be used based on a comparison of similar assets with known values or inflation-adjusted current costs; and
- PP&E accounts be adjusted for disposals, retirements and removal of PP&E, including associated depreciation.

OMB Circular No. A-123, states that transactions should be promptly recorded, properly classified and accounted for in order to prepare timely and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

SFFAS No. 10, *Accounting for Internal Use Software*, provides requirements for the capitalization and reporting of software development costs. GAO's *Standards* require that internal control and all transactions and other significant events are clearly documented and readily available for examination. The Joint Financial Management Improvement Program (JFMIP) *Property Management Systems Requirements*, state that the agency's property management system must create a skeletal property record or have another mechanism for capturing information on property in-transit from the providing entity (e.g., vendor, donator, lender, grantor, etc.).

Recommendations: We recommend that:

1. Coast Guard:
 - a) Improve controls and related processes and procedures to ensure that PP&E, to include additions, transfers, and disposals are recorded accurately, consistently, and timely in the fixed asset system; that an identifying number is entered in the fixed asset system at the time of asset purchase to facilitate identification and tracking; and that the status of assets is accurately maintained in the system;

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- b) Develop and implement internal controls to ensure the quality, sufficiency, and retention of documentation for future PP&E acquisitions and disposals;
 - c) Develop and document methodologies and assumptions to support the value of PP&E that is not evidenced by original acquisition or other sufficient documentation;
 - d) Revise procedures for performing physical inventories of repairable items, to include procedures for resolving differences, and reporting results, to ensure that repairable PP&E is accurately and completely classified and recorded. Support the pricing methodology used to value repairable PP&E to ensure that balances, as presented in the financial statements, approximate amortized historical cost; and
 - e) Review policies and procedures to account for improvements and impairments to buildings and structures, and identify proper useful lives for depreciation purposes.
2. ICE:
- a) Perform a review of its existing software capitalization policy to determine adequacy for financial reporting purposes. The policy should be sufficiently detailed to allow developers and accounting personnel to identify the various phases of the software development life cycle, and the associated accounting treatment, as described in SFFAS No. 10; and
 - b) Develop and implement procedures for developers to track and notify accounting personnel when software has been placed into production so that accounting personnel can properly classify and amortize the software costs.

F. Operating Materials and Supplies

Background: Operating Materials and Supplies (OM&S) are maintained by the Coast Guard in significant quantities, and consist of tangible personal property to be consumed in normal operations to service marine equipment, aircraft, and other operating equipment. The majority of the Coast Guard's OM&S is physically located at either two Inventory Control Points (ICPs) or in the field. The ICPs use the Naval Electronics Supply Support System (NESSS) and the Aircraft Logistics Management Information System (ALMIS) to track inventory, and field held OM&S is recorded in the Configuration Management Plus system. These three systems provide the subsidiary records that support the general ledger's OM&S balance. The Coast Guard's policy requires regularly scheduled physical counts of OM&S, which are important to the proper valuation of OM&S and its safekeeping. The conditions cited below for Coast Guard are based on findings reported in fiscal 2004, updated as necessary to reflect the conditions noted in fiscal year 2005.

Conditions: We noted the following internal control weaknesses related to OM&S at the Coast Guard:

- Internal controls over physical counts at field locations were not designed and implemented to remediate conditions identified during fiscal year 2003 and 2004. In fiscal year 2004, we reported that items were not always properly bar-coded or tagged, on-hand quantities frequently did not agree to the perpetual inventory records, and procedures did not sufficiently address whether all inventory on hand was properly recorded in the perpetual records or require discrepancies to be resolved timely. Coast Guard has acknowledged that the weaknesses continued to exist in fiscal year 2005, and represented their intent to implement corrective action over field held OM&S, to include implementation of internal controls, in fiscal year 2006.

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- Policies, procedures and controls designed to remediate conditions related to conducting physical inventories of OM&S at the ICPs were not completely implemented in fiscal year 2005. ICP physical inventory procedures lacked key elements of an effective physical inventory, e.g., reconciliation of sample population to perpetual records, statistically valid methods of sampling, and proper evaluation and reporting of results. Comprehensive step-by-step physical inventory instructions that clearly addressed each objective of a physical inventory were not communicated in a timely manner in fiscal year 2004, and the Coast Guard has acknowledged that the weaknesses continued to exist in fiscal year 2005. Coast Guard management has represented their intent to implement corrective action over ICP physical inventory procedures, to include implementation of internal controls, in fiscal year 2006.
- Processes and controls were not in place to fully support the calculated value of field-held and ICP OM&S to approximate historical cost. Coast Guard management has represented their intent to implement corrective actions over valuation of OM&S in fiscal year 2006.

Cause/Effect: Coast Guard management deferred correction of most OM&S weaknesses reported in fiscal year 2004 until fiscal year 2006, and acknowledged that the conditions we reported in prior years remained throughout fiscal year 2005. Lack of comprehensive and effective policies and controls over the performance of physical counts, and appropriate support for valuation may result in errors in the physical inventory process, or inventory discrepancies that could result in financial statement misstatements.

Criteria: According to GAO's *Standards*, assets at risk of loss or unauthorized use should be periodically counted and compared to control records. Policies and procedures should be in place for this process. The JFMIP publication *Inventory, Supplies, and Material System Requirements*, states that "the general requirements for control of inventory, supplies and materials consist of the processes of receipt and inspection. An agency's inventory, supplies and materials system must identify the intended location of the item and track its movement from the point of initial receipt to its final destination." SFFAS No. 3, *Accounting for Inventory and Related Property*, states OM&S shall be valued on the basis of historical cost.

Recommendations: We recommend that the Coast Guard:

- a) Update OM&S physical count policies, procedures, and controls, and provide training to personnel responsible for conducting physical inventories;
- b) Implement effective oversight and monitoring procedures to ensure that physical inventory counts are performed, and evaluated in accordance with policies and procedures;
- c) Perform a review of the inventory information contained in NESSS to identify and correct discrepancies between the perpetual records, and actual physical item counts and warehouse locations;
- d) Consider developing risk-based cycle counting procedures for OM&S; and
- e) Provide adequate support for the value of OM&S to approximate historical cost.

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G. Undelivered Orders, Accounts and Grants Payable, and Disbursements

Background: Most of the DHS components estimate accounts payable at year end, for accelerated financial reporting purposes, as a percentage of undelivered orders (UDOs) based on historical trends. UDOs are obligations, or budgetary funds reserved, for good and services ordered but not yet delivered to DHS. Historically, at year-end, DHS has reported approximately \$20 billion in UDOs. Reliable accounting processes surrounding obligations, UDOs, and disbursements are key to the accurate reporting of accounts payable in DHS' financial statements.

ICE had serious difficulties with maintaining accurate financial records related to obligations, UDOs, and disbursements during fiscal year 2005, including the records of DHS-ICE components.

The majority of conditions cited below for Coast Guard are repeated from our fiscal year 2004 report. The Coast Guard has initiated a review of its obligation and procurement processes, including those related to the Integrated Deepwater System, which is targeted for completion in fiscal year 2006.

SLGCP uses its accounting services provider's grants management system to support SLGCP's grant making activities. The grants management system allows grantees to submit their financial status reports electronically via web-based connections.

In late 2004, responsibility for the issuance and related accounting for numerous TSA grant programs was transferred to SLGCP, while TSA retained responsibility for previously issued grants until closeout and certain other grant programs.

Conditions: We noted the following internal control weaknesses related to UDOs, accounts and grants payable, and disbursements, many of which are repeated from fiscal year 2004:

1. ICE has not:

- Established reliable internal controls to ensure that all invoices are paid timely, that all IPACs are cleared from suspense timely, that invoice payments and supporting documentation are matched with an originating obligation prior to disbursement, and that documentation supporting receipt of goods and services required from other Federal agencies for IPAC transactions are verified timely.
- Recorded disbursements made by legacy agencies for prior year obligations of S&T and IAIP at the transaction level timely, because such information was not provided by the legacy agencies timely. Often, disbursements made by legacy agencies were not identified until ICE prepared its FBWT reconciliations and noticed unrecorded disbursements made against S&T and IAIP funds. Unrecorded legacy agency disbursements ranged from a high of almost \$200 million during the second quarter of fiscal year 2005, to approximately \$10 million at September 30, 2005.
- Established sufficient controls to prevent duplicate payments to vendors related to prior year obligations or to prevent negative balances in certain Treasury accounts used by both ICE and the legacy agencies to make disbursements.
- Implemented sufficient controls to ensure that open obligations were properly liquidated when corresponding accounts payable were recorded, and that liquidation was occurring at the proper detailed fund code level.
- Adopted policies related to verification and validation of obligations performed by field personnel that clearly define their responsibilities, including the proper classification of requisitions that require the completion of receiving tickets upon orders being delivered,

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ensuring receipt of services and goods, prior to payment of invoices and communicate the consequences for not adhering to policy.

- Verified the completeness, existence, and accuracy of its recorded obligations created in PRISM, and other ICE systems. ICE did not have effective controls to monitor the completeness of all procurement, and other obligations, created in the field and program offices. For example, UDO subsidiary ledgers are not routinely reconciled to the general ledger.

2. At the Coast Guard:

- The periodic review and validation of UDOs was not properly designed, and was not effective to ensure that recorded obligations were valid, obligations incurred were recorded timely, and that proper approvals and supporting documentation existed. In addition, programming logic and transaction codes used to record advances for which an obligation was not previously recorded are not operating effectively to ensure the obligation and UDO are properly recorded.
- A reconciliation of paid delivered orders to FBWT disbursement activity was not performed. Delivered orders - unpaid were not properly and timely reclassified to delivered orders-paid status when disbursements were made. Instead, Coast Guard made on-top adjustments to delivered orders accounts without supporting detail for financial reporting purposes.
- Policies were not fully implemented to ensure that contract awards were recorded in the general ledger in a timely manner, and as a result, obligations might have been temporarily understated. In addition we noted a lack of segregation of duties associated with the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligation.
- Policies and procedures related to Coast Guard's automated requisition and procurement process have not been consistently followed in all regions. Specifically, the Financial and Procurement Desktop (FPD) system can be overridden to allow non-conforming numbering for purchase requisitions. This created a risk that commitments were not properly tracked or matched with obligations in the accounting records. FPD were also not properly reconciled to the Core Accounting System (CAS), affecting the completeness, existence and accuracy of the year-end "pipeline" adjustment that was made to record obligations executed before year-end, but which were not made into the system prior to year-end close.
- The procurement Management Effectiveness Assessment (MEA), which is an on-site assessment of procurement activity for compliance with Federal statutes and regulations, was not fully performed as planned in fiscal year 2005. The MEA is an important risk assessment, and monitoring control function that, when properly performed, assists in assessing compliance with applicable laws and regulations.
- The process used to estimate accounts payable was not fully documented as to the criteria used to develop the estimate for financial reporting.

3. SLGCP's accounting services provider was unable to resolve discrepancies identified in the data underlying the calculation of SLGCP's grants payable liability at September 30, 2005, prior to the completion of the *DHS Fiscal Year 2005 Performance and Accountability Report*.

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4. TSA:

- Was unable to fully reconcile and support the accuracy and completeness of its accounts payable and UDOs prior to the completion of the DHS *Fiscal Year 2005 Performance and Accountability Report*.
- Did not have policies and procedures in place to validate TSA's fiscal year 2004 grant accrual to ensure the methodology used provided a reasonable estimate of the actual amount owed September 30, 2004. TSA used the same methodology to estimate the grant accrual at September 30, 2005.

5. EPR, SLGCP, and TSA did not have sufficient policies and procedures in place to fully comply with the OMB Circular No. A-133, *Audits of States, Local Governments, and Non-profit Organizations*, and laws and regulations supporting OMB Circular No. A-50, *Audit Follow-up*, as revised.

Cause/Effect: Some of the conditions at ICE resulted from unique circumstances and difficulties with the transfer of S&T, IAIP, and DHS management accounting operations from legacy agencies to ICE in fiscal year 2004. ICE and the DHS OCFO did not establish clear operating procedures or coordinate the sharing of information with legacy agencies. These issues continued in fiscal year 2005, partly because ICE and DHS OCFO management were unable to develop policies and procedures with the legacy agencies requiring the timely transfer of such information. This condition has existed since the inception of the Department in 2003. Further, ICE's system of internal control is weak, allowing financial errors to occur, and be undetected for long time periods. These conditions can also be attributed directly to weaknesses described in Comment A - *Financial Management and Oversight*. In addition procedures for verification and validation of obligations were not clearly written and understood by field personnel. These procedural weaknesses resulted in the misclassification of open obligations and misstatements of undelivered and delivered orders.

The Coast Guard elected to defer correction of most fiscal year 2004 findings we reported in this area until late in fiscal year 2005 and 2006.

Because SLGCP management did not perform sufficient monitoring of its financial reporting processes, SLGCP could not take timely action to ensure that discrepancies noted in the data underlying the grant accrual calculation would not materially impact its financial statement balances. These weaknesses could result in a misstatement of grant payables, expenses, and UDOs.

At EPR, SLGCP, and TSA, if grants are not appropriately monitored, it is possible that funding will not be used for its intended purpose.

Criteria: GAO's *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular No. A-123 states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports." SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, states, "When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated."

Recommendations: We recommend that:

1. ICE:

- a) Establish reliable internal controls to ensure that all invoices are paid timely, all IPACs are cleared from suspense timely, invoice payments are matched with an originating obligation

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prior to disbursement, open obligations are properly liquidated when corresponding accounts payable are recorded, and IPACs are matched with an originating obligation as soon as practicable after the transaction is recorded. Incorporate unique IPAC processing considerations in subsequent disbursement testing procedures;

- b) Establish policies and procedures over disbursements made by ICE operating offices to ensure that disbursements are made only after proper approval of the invoice, and evidence of the receipt of goods and services has been received. The policies should be updated to require the completion of a receiving report for all goods and services before invoices are approved for payment. If necessary, additional training should occur to enhance understanding of the procedures;
 - c) Establish written procedures that require legacy agencies to timely submit all information affecting ICE's accounting for component disbursements, and work with legacy agencies to implement them. If possible, consider transferring all accounting services for prior year obligations from legacy agencies into ICE, and improve procedures to prevent duplicate payments from accounts used by both ICE and its service provider;
 - d) Expand the policies and procedures documentation related to obligation verification and validation to more clearly communicate the process to field personnel, and to ensure that supporting documentation exists to substantiate accounts payable balances;
 - e) Issue policies and procedures that require monthly reconciliations of all obligations created in PRISM, and other manual or automated procurement tracking systems to the general ledger; and
 - f) Adhere to existing policies and procedures requiring UDO subsidiary records be routinely reconciled to the general ledger.
2. Coast Guard:
- a) Improve controls related to processing obligation transactions, to include periodic review and validation of UDOs. Emphasize to all fund managers the need to perform effective reviews of open obligations, obtain proper approvals, and retain supporting documentation. Develop effective monitoring controls for reviewing and approving obligation transactions prior to processing;
 - b) Reconcile paid delivered orders activity to FBWT disbursement activity, to ensure that delivered orders are moved from unpaid status properly and timely, and to eliminate the current practice of making unsupported on-top adjustments to delivered orders for financial reporting purposes;
 - c) Improve segregation of duties for transactions related to the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligations, and record contracts timely;
 - d) Evaluate programming logic and transactions codes used to record advances for which an obligation was not previously recorded to ensure the obligation and UDO is properly recorded;
 - e) Update the program logic of FPD to improve controls over document numbering for purchase requisitions. The system design of FPD and the core accounting system should be evaluated to ensure that obligation transactions are correctly processed;

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- f) Reconcile FPD to CAS to ensure the completeness, existence, and accuracy of the year-end “pipeline” adjustment that is made to record obligations executed before year-end but not recorded in the system prior to year-end close;
 - g) Revise Commandant Instruction 4200.30B, *Program Management Review Program*, in order to implement effective oversight and monitoring procedures of the contract acquisition process, including the frequency of MEAs at major procurement regions; and
 - h) Improve documentation of policies, procedures, and controls over the accounts payable estimation process.
3. SLGCP should require its accounting services provider to (a) perform a review to correct discrepancies in the underlying grant data, (b) complete a full validation of the SLGCP grants payable, as presented in the DHS consolidated balance sheet at September 30, 2005, to determine if it is materially misstated, and (c) record a correcting adjustment if necessary to completely and accurately state the balance.
 4. TSA:
 - a) Perform a review to assess whether TSA accounts payable and UDOs, as presented in the DHS consolidated balance sheet at September 30, 2005, are materially misstated and record a correcting adjustment, if necessary, to completely and accurately state the balances; and
 - b) Implement policies and procedures to annually validate that the methodology used to estimate its grant accrual provides a reasonable estimate of the actual amount owed.
 5. EPR, SLGCP, and TSA implement policies and procedures to ensure full compliance with OMB Circular Nos. A-133 and A-50.

H. Actuarial Liabilities

Background: The Coast Guard maintains pension, medical, and post-employment travel benefit programs that require actuarial computations to determine the proper liability for financial reporting purposes. The Military Retirement System (MRS) is a defined benefit plan that covers both retirement pay and health care benefits for all active duty and reserve military members of the Coast Guard. The post-employment travel benefit program is a benefit program that pays the cost of transportation for uniformed service members upon separation from the Coast Guard. The unfunded accrued liability for both plans is reported in the DHS consolidated balance sheet at September 30, 2005 and 2004. Annually, participant data is extracted by Coast Guard from its records, and provided to an actuarial firm as input for the liability calculations. The accuracy of the actuarial liability as reported in the consolidated financial statements is dependent on the accuracy and completeness of the underlying participant data provided to the actuary.

Conditions: The Coast Guard:

- Was unable to fully support its assertions relating to accuracy and completeness of the underlying participant data, medical cost data, and trend and experience data provided to, and used by, the actuary for the calculation of the MRS, and post employment travel benefits liabilities. In addition, the salary increase assumptions used by the actuary in the MRS liability were outdated, and the Coast Guard did not have an established process to inform the

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actuary of Congressional legislation that changed allotments, entitlements, calculation methods, and amounts of military pay, which could materially affect the calculation of actuarial liabilities.

- Did not follow established policies and procedures to accumulate data for the actuary to compute post-employment travel benefits. The actuary determined that the data was unreliable and; therefore, could not complete their work. In addition, the Coast Guard's post-employment travel liability at September 30, 2005, did not reflect the most current participant data.
- Did not perform periodic reconciliations between the medical expenditures subsidiary ledger and the general ledger, which would have identified errors in underlying data. In addition, the Coast Guard did not perform a reconciliation of the payroll system data to military personnel records to ensure the accuracy of headcount information prior to the submission of data to the actuary.
- Did not have effective policies, procedures, and controls to monitor the expenditures for medical services to ensure they were billed at proper rates, and for valid participants only, e.g., service members and their families, and retiree/survivors.

Cause/Effect: The Coast Guard does not have well-established procedures in place, including adequate internal controls, such as supervisory reviews, to ensure that data and other information provided to the actuary is complete and accurate. Much of the data required by the actuary comes from personnel and payroll systems that are outside of Coast Guard's accounting organization, and are instead managed by Coast Guard's Personnel Service Center (PSC). Strong lines of communication are needed between PSC and accounting personnel. In addition, it appears that the definition of data requirements provided to the PSC is not always clear, resulting in incomplete or inaccurate data being submitted to the actuary, that was not discovered until after the actuary identifies data anomalies, or the underlying participant data is subjected to our audit procedures. As a result of weak controls, errors were discovered too late in the year for corrective action to occur, and the Coast Guard's actuary to recompute the pension and other post-retirement liabilities to accurately state those balances in the DHS consolidated balance sheet as of September 30, 2005.

The Coast Guard could be billed for services provided to non-Coast Guard participants/sponsors. Inaccurate medical costs submitted to the Coast Guard actuary could result in a misstatement of the actuarial medical liability and related expenses.

Criteria: GAO *Standards* state that management is responsible for developing policies, procedures, techniques, and mechanisms that enforce management's directives. Control activities include approvals, authorizations, verifications, reconciliations, performance review, and the creation and maintenance of related records that provide evidence of execution of these activities, as well as appropriate documentation.

SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, paragraph 95 states; the employer should recognize an expense and a liability for other post-employment benefits (OPEB) when a future outflow or other sacrifice of resources is probable and measurable on the basis of events occurring on or before the reporting date. Further, the long-term OPEB liability should be measured at the present value of future payments, which requires the employer to estimate the amount and timing of future payments, and to discount the future outflow over the period for which the payments are to be made.

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Recommendations: We recommend that the Coast Guard:

- a) Establish and document specific procedures and internal controls to provide review and oversight of its actuarial firm, to ensure that appropriate assumptions and accurate data, e.g., participant, medical cost, trend and experience, are used by the actuary to develop the estimate for post-employment actuarial liabilities, to include MRS and post employment travel benefits;
- b) Perform a periodic reconciliation between the medical expenditures recorded in the subsidiary ledger and those recorded in the CAS, and clearly identify reasons for variances in expenditures and UDOs. This reconciliation should be performed for all significant sources of medical actuarial data, including TriCare, and DoD Military Treatment Facilities (MTFs). In addition, this reconciliation should be reviewed by someone other than the preparer to ensure accuracy. The reviews / reconciliations should:
 - Determine whether personnel data and retroactive payroll transactions are negatively impacting other business processes such as payroll and/or budgeting, and take corrective action as appropriate; Institute an annual review of data from the active/reserve population submitted to the actuary to determine if member attributes are complete and accurate, and follow up on any errors in order to correct them;
 - Assess the impact of year-end retroactive payroll transactions on data populations provided to Coast Guard actuary;
 - Review of the spreadsheet used to record and monitor medical expenses, to identify and correct any technical errors;
 - Include an update to the current experience studies to provide more accurate trend information for Coast Guard, as recommended by Coast Guard's actuary;
 - Review the annual headcounts provided by the PSC to the actuary, specifically by reconciling and resolving any discrepancies between payroll data to personnel data to ensure completeness and accuracy
- c) Perform an analysis of its policies, procedures, and systems to determine why certain IT system interfaces or query programs did not reliably process attribute data provided to the actuary and to identify key controls that were absent or ineffective; and
- d) Monitor medical care costs, including incurred but not reported costs. These procedures could include analysis of monthly medical cost payment trends, and related evaluations of trends to assess the accuracy and consistency of billings (between the military services), and for various treatment types (e.g., in-patient, out-patient). Such a trend analysis could assist the Coast Guard in budgeting medical payment costs for future periods. Verify that MTFs only bill for services provided to eligible Coast Guard participants and sponsors.

I. Budgetary Accounting

Background: Budgetary accounts are a category of general ledger accounts where transactions related to the receipt, obligation, and disbursement of appropriations and other authorities to obligate and spend agency resources are recorded. Combined ICE and DHS-ICE components have over 90 separate TAFS, each with separate budgetary accounts that must be maintained in accordance with

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OMB and Treasury guidance. The Coast Guard also has a complex budget that includes budget authority from a variety of sources: annual, multi-year, and no-year appropriations; and several revolving, special, and trust funds. In total, the Coast Guard has over 80 separate Treasury fund symbols where budgetary authority is accounted for separately.

In fiscal year 2005, TSA migrated to the Coast Guard's financial systems, and Coast Guard became TSA's accounting services provider.

Conditions: We noted the following internal control weaknesses related to budgetary accounting, many of which were repeated from fiscal year 2004:

1. At ICE and DHS-ICE components:

- Weaknesses existed in controls that might have allowed ICE and DHS-ICE components to violate the *Antideficiency Act*, or prevented management from knowing if they were in violation. Circumstances existed during the year that indicated a strong possibility that ICE funds were insufficient to cover obligations. ICE management and the DHS OCFO commenced an internal review to determine the extent of unrecorded obligations at ICE because of ICE's ongoing budgetary accounting difficulties; however, the internal review was suspended prior to its completion. Identification of potential unrecorded obligations is contemplated as part of ICE's *Financial Action Plan* to be executed in fiscal year 2006. As stated in our *Independent Auditors' Report*, we were unable to complete our audit of the financial statements as of, and for the year ended September 30, 2005, and accordingly, we were unable to complete our procedures related to testing for ICE's compliance with the *Antideficiency Act*.
- Obligations for ICE and the DHS-ICE components were not always recorded in a timely manner. We noted many instances during the year when goods and services were procured before available funding was confirmed, and without an obligating document recorded in the system. We noted instances where invoices were held for payment due to for lack of funds. Because of the deterioration of the timeliness of recording obligations at ICE that were identified during the first half of fiscal year 2005, the Assistant Secretary for ICE intervened by issuing an instruction to all ICE program offices in April 2005 to record all known obligations. This was reiterated by an instruction in June 2005 from the Acting CFO, in preparation for the June 30, 2005, hard close.
- The listing of open obligations in ICE's core accounting system (FFMS) was not complete and accurate for ICE and all DHS-ICE components. Obligations were recorded or modified in FFMS without verifying that the obligation data keyed into FFMS agreed with supporting documentation. We noted instances where obligations were partially recorded and instances where the obligation was not recorded related to services that were provided over a period that crossed fiscal years. We also noted an instance where an obligation was not properly authorized before it was entered into FFMS.
- The transfer of accounting records and responsibilities from legacy agencies was not coordinated properly. Ending balances for budgetary accounts maintained by legacy agencies often did not equal the beginning balances shown in the DHS-ICE component's financial records, dating back to the inception of the Department in 2003. During fiscal year 2005, legacy agencies continued to approve and pay for prior year obligations, without providing timely information that ICE needed to update the relevant accounting records.

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Appendix I – Material Weaknesses in Internal Control

- Certain Customs and Border Patrol (CBP) obligations, and the related disbursements, were retained in the accounting records of ICE upon the transfer of certain operations from ICE to CBP. However, the fiscal year 2005 transactions and remaining obligations were not reported to CBP timely, causing misstatements in the financial statements of both components.
 - Contracting officer approvals were not clearly documented on obligating documents, and in one instance a contracting officer approved a purchase for an amount in excess of the officer's warrant authority. Further, ICE and the DHS-ICE components were unable to provide a complete and accurate listing of contracting officers with their approval thresholds.
 - Weaknesses existed in controls over the preparation, submission and reconciliation to the general ledger of the SF-132, and the SF-133. Information reported on the SF-133 did not agree with the accounting records and was not reconciled timely resulting in inaccuracies in the June 2005 financial statements for ICE and the DHS-ICE components.
2. At Coast Guard:
- Obligations related to post-employment permanent changes of station (PCS) were not recorded at the time orders were approved and issued.
 - The electronic validation and edit checks within the FPD, a feeder system to the CAS, were not fully utilized. Use of such a control is one method that would allow the Coast Guard to automatically flag and prevent the recording of commitments (a reservation of funds for future obligation) and obligations in excess of appropriations, apportionments, or allotments.
 - Obligations were recorded in FPD, but were not properly interfaced with the CAS, and were not supported by adequate documentation.
 - Weaknesses existed in system capabilities and controls over the recording of budgetary authority. The Coast Guard's financial systems were unable to record budget authority until it had been apportioned, which resulted in temporary understatements of budget authority for certain types of funding sources, e.g., transferred authority, that is not typically apportioned before receipt of the funds.
 - No automated system controls existed to preclude the processing of procurement transactions if the contracting officer's warrant authority had expired, and a manual check compensating control was not effective since listings of warranted contracting officers were outdated.
 - Commitments were not routinely monitored for aging, or released timely, so that funds could be committed and obligated elsewhere. As of September 30, 2005, Coast Guard had recorded unobligated commitments prior to fiscal year 2005 totaling \$57 million.
3. The CAS used by TSA's accounting service provider, did not have the functionality to record amounts deobligated from prior year obligations at the transaction level, in accordance with the SGL requirements.

Cause/Effect: Many of the budgetary accounting issues at ICE appeared to be systemic in nature, rooted in inadequate financial management processes, together with a lack of discipline in the operating offices to follow prescribed policies. In addition, the internal control system is weak, allowing financial errors to occur, such as unrecorded obligations, and go undetected by employees in the normal course of business. These conditions can also be attributed directly to weaknesses described in Comment A - *Financial Management and Oversight*. Several of the conditions at ICE

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Appendix I – Material Weaknesses in Internal Control

remain from difficulties with the transfer of the accounting operations of DHS-ICE components from legacy agencies to ICE in fiscal year 2004. ICE and legacy agency management did not coordinate the transition process to ensure that all transactions were properly recorded in the general ledgers of DHS-ICE components during the transfer of accounts to ICE.

Several of the Coast Guard's budgetary control weaknesses can be corrected by modifications or improvements to the financial accounting system, process improvements, and strengthened policies. The Coast Guard has deferred correction of these conditions until fiscal year 2006.

Weak controls in budgetary accounting, and associated contracting practices increase the risk that DHS and its components could violate the *Antideficiency Act*, and overspend their budget authority. The financial statements are also at greater risk of misstatement. The untimely release of commitments may prevent funds from being used timely for other purposes.

Criteria: The *Antideficiency Act* prohibits agencies from obligating or disbursing more than their appropriations and apportionments, has strict requirements for reporting violations, and includes penalties for violations. GAO *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, requires Federal agencies to submit their apportionment requests on an SF-132 for each appropriation, unless permission is granted otherwise, and provides guidance on when it is proper to record obligations for financial reporting purposes. According to JFMIP's *Core Financial System Requirements* publication, an agency's core financial management system must ensure that an agency does not obligate or disburse funds in excess of those appropriated and/or authorized, and specific system edits and user notifications related to funds control must be in place. The *Federal Acquisition Regulation (FAR)* Section 1.16 addresses the authorities and responsibilities granted contracting officers. Treasury's SGL guidance specifies the accounting entries related to budgetary transactions.

Recommendations: We recommend that:

1. ICE and DHS-ICE components:
 - a) Perform a root cause analysis of the financial management process, including relevant IT systems, to identify the reasons why obligations were not recorded accurately and timely during fiscal year 2005. If the review identifies violations of the *Antideficiency Act* that occurred during fiscal year 2005 or 2004, each instance of non-compliance should be reported in accordance with U.S.C. Title 31;
 - b) Redesign the procurement process, as necessary, and establish appropriate internal controls to ensure that all obligations are accurately entered into FFMS in a timely manner, in accordance with applicable accounting standards, e.g., OMB Circular No. A-11, including transactions conducted by legacy agencies for DHS-ICE component entities, and transactions made on behalf of other DHS components, e.g., CBP for transferred operations;
 - c) Verify and validate the completeness and accuracy of obligations currently recorded in FFMS, and that all obligations have been properly approved by a contracting officer with the appropriate authority to approve the transaction;
 - d) Improve policies and procedures to ensure that adequate documentation, including contracting officer approvals, is maintained to support all obligations; and
 - e) Improve policies and procedures related to preparation and reconciliation of the SF-132 and SF-133 with differences investigated and properly corrected.

Independent Auditors' Report**Appendix I – Material Weaknesses in Internal Control**

2. Coast Guard:

- a) Implement procedures to ensure that obligations related to PCS are recorded at the time orders are approved and issued, and supporting documentation is maintained;
- b) While no violations were noted, consider activating the electronic edit checks in FPD to the general ledger system to prevent incurring commitments and obligations in excess of appropriations and apportionments, and establish automated controls to prevent the processing of procurement transactions by contracting officers who do not have active warrant authority;
- c) Revise controls and related policies and procedures to periodically review commitments, e.g., monitor aging, and determine the feasibility of modifying FPD to transmit all commitments, regardless of dollar amount, to the general ledger system, and to properly interface FPD with CAS;
- d) Implement a system change to the general ledger accounting system posting logic, to properly record budget authority;
- e) Develop and implement policies and procedures to ensure that the certification process is effective, and year-end obligations not recorded in CAS are validated, accurate, and supported by proper documentation; and
- f) Develop and provide specific training related to any internal controls and related policy and procedure changes.

- 3. TSA, in coordination with its accounting services provider, should establish the necessary program logic in CAS to capture and report amounts deobligated from prior year obligations at the transaction level, in accordance with the SGL requirements.

J. Intragovernmental and Intradepartmental Balances

Background: DHS conducts business with other Federal agencies resulting in intragovernmental receivables, payables, and the reporting of revenues and expenses from intragovernmental transactions. Federal accounting and reporting regulations require Federal agencies to routinely identify and reconcile intragovernmental balances and transactions with trading partners. These procedures help ensure that intragovernmental balances properly eliminate in the government-wide consolidated financial statements. DHS components also conduct business with each other, resulting in the same type of transactions and balances that must be eliminated against each other to produce accurate consolidated financial statements for DHS.

Conditions: During fiscal year 2005, including the fourth quarter, DHS did not timely or completely reconcile intragovernmental balances with other Federal entities, particularly the Department of Defense. Consequently, the DHS' *Material Difference/Status of Disposition Certification Report*, submitted to Treasury for September 30, 2005, showed material differences attributable to accounting/reporting errors in excess of \$1.6 billion. These conditions also impacted DHS' ability to accurately report transactions with Federal government trading partners in the consolidated financial statements, and in the RSI section of the financial statements, as required. The DHS OCFO did not perform reconciliations throughout the year of all intragovernmental balances. We noted that ICE, DHS-ICE components, and Coast Guard have not developed and adopted effective SOPs, or established systems to completely track, confirm, and reconcile intra-governmental balances and/or transactions with trading partners, in a timely manner, which contributed to the material differences.

Independent Auditors' Report**Appendix I – Material Weaknesses in Internal Control**

We did note a decrease in out-of-balance conditions from the prior year and during fiscal year 2005. However, DHS was still unable to produce accurate consolidated financial statements due, in part, to unreconciled eliminations between DHS components in a timely manner. Intra-DHS transactions between ICE, CBP, CIS and other DHS components did not eliminate correctly at the consolidated level during the year. Further, DHS was unable to completely reconcile out-of-balance intradepartmental transactions at year-end, resulting in the need for “on-top” adjustments, based primarily on estimates and analytical comparisons, to close the general ledger and prepare balanced consolidated financial statements.

Cause/Effect: Business process limitations at ICE, DHS-ICE components, and the Coast Guard prevented these components from tracking activity with government trading partners and thus, manual processes were established. Accounting data for DHS-ICE components did not include detailed supporting schedules of trading partner activity that would have facilitated the reconciliation process. The Coast Guard has not fully utilized its accounting system functionality to identify and track intragovernmental balances. A lack of resources in the OCFO prevented the accountant responsible for intragovernmental reconciliations from researching and reconciling intragovernmental differences in a timely manner during the year and at year-end. Reconciling trading partner activity and balances at least quarterly is necessary to identify material out-of-balance conditions between Federal entities and to support an accurate consolidation of DHS and the Government-wide financial statements.

Criteria: The *Treasury Financial Management Service Memorandum M-03-01*, dated October 4, 2002, provides guidance to Federal agencies for standardizing the processing and recording of intragovernmental activities. The *Treasury Federal Intragovernmental Transactions Accounting Policies Guide*, dated October 23, 2002, requires quarterly reconciliation of intragovernmental asset, liability, and revenue amounts with trading partners. Further, the TFM, Section 4060, *Intragovernmental Activity/Balances*, requires reporting agencies to reconcile and confirm intragovernmental activity and balances quarterly for specific reciprocal groupings. OMB Circular No. A-136 requires the presentation of transactions with trading partners to be presented in RSI. It also requires agency financial statements to be presented on a consolidated basis, including the elimination of significant intradepartmental transactions and balances for reporting purposes.

Recommendation: We recommend that all DHS components and programs, in conjunction with the DHS OCFO, develop and implement procedures to positively confirm and reconcile, at least on a quarterly basis, all intragovernmental activity and balances with their intragovernmental trading partners, including other DHS component entities, as prescribed by Treasury guidance. In addition, transactions with trading partners should be completely and accurately presented in the RSI section of the Department's PAR. These procedures also should ensure that all intradepartmental activity and balances are identified and properly eliminated for DHS' consolidated financial statements.

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Appendix II – Other Reportable Conditions

K. Environmental Liabilities

Background: The Coast Guard's environmental liabilities consist of two main types: shore facilities and vessels. Shore facilities include any facilities or property other than ships and aircraft (e.g., buildings, fuel tanks, lighthouses, small arms firing ranges, batteries from aids to navigation, etc.).

The Plum Island Animal Disease Center (PIADC) was transferred to DHS from the Department of Agriculture and is dedicated to the study of animal diseases to better protect the food supply. Previously the PIADC was a U.S. Army installation. The type of research conducted at PIADC and its past use as a military facility are indicators that the land and buildings may require substantial environmental clean-up to eliminate environmental contaminants. PIADC is now part of DHS' S&T Directorate.

CBP's environmental liabilities are created primarily from underground fuel storage tanks and firing ranges.

Conditions: We noted the following internal control weaknesses related to DHS' environmental liabilities:

1. At Coast Guard:
 - Consistent policies or procedures have not been developed for the identification, evaluation, and estimation of potential environmental remediation of Coast Guard sites, thereby resulting in different approaches by shore facility commands and ultimately varying liability estimates.
 - Environmental liability estimates associated with lighthouses and light stations did not include future Phase II (soil testing) assessment or remediation costs and will not be completed until fiscal year 2006.
 - The total estimate for shore facilities was misstated due to ineffective procedures. We noted that the Coast Guard did not properly index the liability costs to current year dollars, nor did it properly include contingency factors for unknown conditions, resulting in a potential understatement of the shore facility liability in the financial statements.
 - Consistent policies and procedures have not been developed to estimate the cost of remediation of specific projects, such as lighthouses and small arms firing ranges and will not be completed until fiscal year 2006.
 - Segregation of duties in calculating and reviewing the vessels liability estimates did not exist.
 - Policies and procedures had not been developed to review shore facility project estimates that would provide reasonable coverage of the entire shore facility population.
2. At S&T, policies and procedures have not been developed to determine if an environmental liability exists at the PIADC, and if so, to accurately estimate and record an environmental liability for the cost of cleanup.
3. CBP had not determined the environmental liabilities to be recorded in the September 30, 2005, financial statements, until a review was performed in response to our audit inquiry. CBP's analysis resulted in an environmental liability of approximately \$43 million. We further noted that no single program existed to manage CBP's environmental liabilities, resulting in the necessity for an ad hoc process to be implemented at year-end. In addition, we noted a lack of communication throughout the organization, related to the requirements associated with

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environmental liabilities and weaknesses in documentation of data supporting the computation of liability for financial statement purposes.

Cause/Effect: Coast Guard has not developed consistent written agency-wide policies, to define the technical approach, cost estimation methodology, and overall management of its environmental remediation projects, resulting in inconsistency in its estimates and possible misstatement of the liability in its financial statements. S&T and CBP did not have policies and procedures in place that required an annual review to identify a comprehensive list of sites that required environmental remediation and clean-up.

Criteria: SFFAS No. 6, paragraph 85, defines environmental cleanup costs as those costs for removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated PP&E. Paragraph 88 states that these cleanup costs meet the definition of liability provided in SFFAS No. 5. In addition, SFFAS No. 6, paragraph 96, states that remediation estimates shall be revised periodically to account for material changes due to inflation or deflation and changes in regulations, plans and/or technology. New remediation cost estimates should be provided if there is evidence that material changes have occurred; otherwise estimates may be revised through indexing.

FASAB Technical Release No. 2, *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government*, states that an agency is required to recognize a liability for environmental cleanup costs as a result of past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable. Probable is related to whether a future outflow will be required. Reasonably estimable relates to the ability to reliably quantify in monetary terms the outflow of resources that will be required.

The GAO *Standards* state that management is responsible for developing and documenting detailed policies, procedures, and practices that fit their agency's operations. As part of their monitoring of internal control, management must continue to maintain these policies and procedures and assess the quality of performance over time.

Recommendations: We recommend that:

1. Coast Guard:
 - a) Implement policies and procedures to ensure the proper calculation and review of cost estimates for consistency and accuracy in financial reporting including determining proper segregation of duties;
 - b) Develop controls to ensure identification of and recording of all environmental liabilities, such as, soil testing and remediation, lighthouses, small arms ranges, and vessels; and continue efforts to implement corrective action plans regarding small arms firing ranges (SAFR) and lighthouse/light station remediation projects; and
 - c) Develop and implement policies and procedures to apply indexing and contingencies to environmental estimates on a consistent basis, and to require the retention of supporting documentation for environmental estimates.
2. S&T evaluate the PIADC facility, using a qualified environmental specialist, to determine if an environmental liability exists, and if so to accurately estimate and record an environmental

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Appendix II – Other Reportable Conditions

liability for the cost of cleanup. S&T should also develop policies and procedures to routinely assess environmental liabilities.

3. CBP:

- a) Designate one central person or department to be responsible for management and reporting of environmental liabilities, e.g., identification, valuation, tracking, and financial statement reporting;
- b) Improve the communication throughout CBP to ensure that a clear understanding of the financial reporting requirements for environmental liabilities exists;
- c) Implement a process to ensure that all sites with potential environmental liabilities are identified and liabilities are properly estimated and recorded in the financial statements, in accordance with generally accepted accounting principles;
- d) Ensure that the liability is updated on a quarterly basis; and
- e) Improve the traceability of its Environmental Liabilities Summary Sheet estimate to its supporting documentation.

L. Custodial Revenue and Drawback

Background: CBP, as a component of DHS, has continued to perform an important revenue collection function for the U.S. Treasury. CBP collects approximately \$24 billion in annual import duties, taxes, and fees on merchandise arriving in the United States from foreign countries. Receipts of import duties and related refunds are presented in the statement of custodial activity in the DHS consolidated financial statements. CBP is the only DHS component with significant custodial responsibilities.

Drawback is a remittance, in whole or in part, of duties, taxes, or fees previously paid by an importer. Drawback typically occurs when the imported goods on which duties, taxes, or fees have been previously paid, are subsequently exported from the United States or destroyed prior to entering the commerce of the United States. Depending on the type of claim, the claimant may have up to eight years from the date of importation to file for drawback.

CBP employs a risk-based system of internal control over the collection of taxes, duties, and fees. By design, imports are subjected to various controls depending on a risk assessment associated with the importer, country of origin, merchandise being imported to the United States, and other factors. Low risk imports are subjected to fewer trade compliance controls, while high risk imports are subjected to increased control, e.g. inspection, review of import documentation, etc. To measure the effectiveness of this risk-based control approach, CBP uses a technique known as Compliance Measurement Program (CMP), which is essentially a control self-assessment. The CMP is also used to compute the “revenue gap”, as described by SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*, and disclosed in the CBP’s PAR in compliance with OMB Circular No. A-136.

Bonded Warehouses (BW) are facilities under the joint supervision of CBP and the Bonded Warehouse Proprietor used to store merchandise that has not made entry into the United States commerce. Foreign Trade Zones (FTZ) are secured areas under CBP supervision that are considered outside of the CBP territory, upon activation. Authority for establishing FTZs is granted by the U.S. Department of Commerce’s Foreign Trade Zones Board, under the *Foreign Trade*

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Zones Act of 1934, as amended (19 U.S.C. 81a-81u). Foreign and domestic merchandise may be admitted into zones for operations not otherwise prohibited by law, including storage, exhibition, assembly, manufacturing, and processing.

Conditions: We noted the following internal control weaknesses at CBP:

Related to drawback:

- The revenue accounting system, Automated Commercial System (ACS), lacked controls to detect and prevent excessive drawback claims and payments, necessitating inefficient manual processes to compensate. ACS did not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries or export documentation upon which the drawback claim was based. For example, ACS did not contain electronic edit checks that would flag duplicate claims for export of the same merchandise.
- Drawback review policies did not require drawback specialists to review all related drawback claims against the underlying consumption entries to determine whether, in the aggregate, an excessive amount was claimed.

Related to the entry process – collection of taxes, duties and fees, and CMP:

- Policies and procedures that describe how to perform a CMP exam, the role of the CM coordinator, and documentation of findings, etc. were outdated and not well documented or communicated. We noted that performance of the CMP has been inconsistent in various ports throughout the United States. For example we noted that the extent of physical inspection of merchandise varied depending upon the port and inspector performing the inspection.
- CBP management identified other weaknesses in the documentation and accumulation of CMP sample data that could mitigate the effectiveness of the program as a quality control measurement tool, and the accuracy of the revenue gap disclosed in the CBP PAR. For example, we noted that CMP sample data was not reviewed for errors before it was used by a statistician to compute the revenue gap, and CBP identified a high error rate in the quality of other, non-financial CMP generated data.
- The CMP sample size used during fiscal year 2005 was lower than in previous years, and consequently caused a high standard deviation of potential error in the statistical computation of the revenue gap.

Related to BW and FTZ:

- CBP lacked official guidance and proper training to address the monitoring of BWs and FTZs. For example, we identified incomplete risk assessments and spot checks of BWs and FTZs.
- CBP has not implemented a CMP to measure the revenue gap and effectiveness of controls over trade compliance at FTZs and BWs, similar to the entry process described above.

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Cause/Effect: CBP has been challenged to balance its commitment of limited resources to two important mission objectives – trade compliance, including the collection of taxes, duties and fees owed to the Federal government, and securing the U.S. borders from potential terrorist entry. While these mission objectives do overlap somewhat, there are differences in how resources are deployed. During fiscal year 2005, CBP reduced its sample size for its CMP by a factor of 50 percent, to devote more resources to border security. Further, CMP policies and procedures have not gone through a significant review and update in several years. Turnover and reassignment of personnel have caused the CMP knowledge base to go stale in some ports. For drawback, much of the process is manual until planned IT system functionality improvements are made, placing an added burden on limited resources. Policies and procedures have not been developed or implemented to reliably and accurately review and track the BWs and FTZs. Without an effective process to review the compliance of CBW and FTZ, CBP cannot determine the loss of revenue associated with these facilities, and it is possible that some of the facilities were not accounted for and that others were counted twice.

Criteria: Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. OMB's *Revised Implementation Guidance for FFMA*, states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations. JFMIP publications and OMB Circular No. A-127 outlines the requirements for Federal systems. JFMIP's *Core Financial System Requirements* states that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities. Circular No. A-127 requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Wherever appropriate, data needed by the systems to support financial functions should be entered only once and other parts of the system should be updated through electronic means consistent with the timing requirements of normal business/transaction cycles.

The *Improper Payments Information Act of 2002*, effective in fiscal year 2004, requires agencies to assess the risk of erroneous payments and develop a plan to correct control weaknesses. In addition to the regulatory requirements stated above, CBP's *Drawback Handbook*, dated July 2004, states that management reviews are necessary to maintain a uniform national policy of supervisory review.

Recommendations: We recommend that CBP:

Related to drawback:

- a) Implement effective internal controls over drawback claims as part of any new systems initiatives, including the ability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and export documentation for which the drawback claim is based, and identify duplicate or excessive drawback claims; and
- b) Revise current policies and procedures to require drawback specialists to review all prior related drawback claims against a designated consumption entry to determine whether, in the aggregate, an excessive amount was claimed against the consumption entries.

Related to entry and CMP:

- c) Update policies and procedures to fully describe how to perform a CMP exam, define the roles and responsibilities of the CM coordinator, and to describe how to document test results to improve the quality of CMP data;

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- d) Provide training to CM coordinators, CBP officers and import specialists on how to fully achieve the objective of the CMP; and
- e) Develop and implement additional procedures that will improve the precision of the revenue gap calculation, including the statistical results.

Related to FTZ and BW:

- f) Finalize and issue CBP policies and provide appropriate training regarding compliance reviews of FTZs and BWs. This policy should include a standard national checklist to help CBP officers perform thorough reviews and measure compliance rates and to document the reviews consistently. In addition, this policy should include specific corrective action plans, based on the inspection results; and
- g) Consider the cost/effectiveness of implementing a CMP over FTZs and BWs to assess the risk of revenue loss and violations of trade regulations by importers.

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Appendix III – Compliance and Other Matters

(Findings A – J and K – L are presented in Appendices I and II, respectively)

M. Federal Managers' Financial Integrity Act of 1982

OMB Circular No. A-123 requires agencies and Federal managers to (1) develop and implement management controls; (2) assess the adequacy of management controls; (3) identify needed improvements; (4) take corresponding corrective action; and (5) report annually on management controls (commonly known as management's FMFIA report). During fiscal year 2005, DHS OCFO significantly enhanced its FMFIA assessment policies and procedures to be conducted by the components, in part to prepare for an audit of internal control over financial reporting in fiscal year 2006, pursuant to the *DHS Financial Accountability Act of 2004*. The OCFO required the components to implement certain processes and undergo a self evaluation of some entity level controls.

While also we noted a considerable improvement in DHS' FMFIA processes, some components still have not established effective systems, processes, policies and procedures to evaluate and report on internal accounting and administrative controls, and conformance of accounting systems to properly and accurately report on compliance with Sections FMFIA Sections 2 and 4.

Recommendations: We recommend that DHS components fully implement the FMFIA process, as prescribed by the OCFO, to ensure compliance with the FMFIA in fiscal year 2006. We also recommend that the OCFO consider additional training for the components, to ensure a thorough understanding of requirements.

N. Federal Financial Management Improvement Act of 1996

Passage of the *DHS Financial Accountability Act of 2004* made DHS subject to the FFMIA, in fiscal year 2005. In previous fiscal years – 2003 and 2004 – DHS was not subject to FFMIA. Section 803(a) of FFMIA, requires that agency Federal financial management systems comply with (1) Federal accounting standards, (2) Federal system requirements, and (3) the United States Standard General Ledger at the transaction level. FFMIA emphasizes the need for agencies to have systems that can generate timely, reliable, and useful information with which to make informed decisions to ensure ongoing accountability. We noted that DHS and each significant component – CBP, ICE and DHS-ICE components, EPR, SLGCP, TSA and Coast Guard did not fully comply with at least one of the requirements of FFMIA. The reasons for non-compliance are reported in Appendices I and II.

Recommendations: We recommend that DHS improve its processes to ensure compliance with the FFMIA in fiscal year 2006.

O. Federal Information Security Management Act (Electronic Government Act of 2002)

DHS is required to comply with the FISMA, which was enacted as part of the *Electronic Government Act of 2002*. FISMA requires agencies and departments to: (1) provide information security for the systems that support the operations under their control; (2) develop, document and implement an organization-wide information security program; (3) develop and maintain information security policies, procedures and control techniques; (4) provide security training and oversee personnel with significant responsibilities for information security; (5) assist senior officials concerning their security responsibilities; and (6) ensure the organization has sufficient trained personnel to comply with FISMA requirements. We noted instances of non-compliance with FISMA that have been reported by us in Appendix I within Comment C– *Financial Systems Security*.

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Recommendations: We recommend that DHS follow the recommendations provided in Appendix I, Comment C and fully implement the requirements of FISMA in fiscal year 2006.

P. *Single Audit Act Amendments of 1996, and Laws and Regulations Supporting OMB Circular No. A-50, Audit Follow-up, as revised,*

As grant-making agencies, EPR, SLGCP, and TSA are required to comply with certain provisions of OMB Circular No. A-133 and OMB Circular No. A-50, as revised. These circulars require agencies awarding grants to ensure they receive grantee reports timely and to follow-up on grantee single audit findings.

Additional, OMB Circular No. A-50, as revised, provides policies and procedures for use by executive agencies when considering reports issued by Inspectors General, and other executive branch audit organizations, the GAO, and non-Federal auditors, where follow up is necessary. Corrective action taken by management on findings and recommendations is essential to improve the effectiveness and efficiency of government operations.

Although certain procedures have been implemented to monitor grantees and their audit findings, we noted that EPR, SLGCP, and TSA did not have procedures in place to fully comply with provisions in OMB Circular Nos. A-133 and A-50, that require them to timely obtain and review grantee single audit reports and follow up on questioned costs and other matters identified in these reports. Since single audits typically are performed by other entities outside of DHS, procedures related to these reports are not always entirely within the control of EPR, SLGCP, and TSA.

DHS and its components did not fully develop corrective action plans to address all material weaknesses and reportable conditions identified by previous financial statement audits, and in two cases, management did not provide a response to fiscal year 2004 audit findings, as required by OMB Circular No. A-50, as revised. We also noted that some corrective action plans lack sufficient detail, such as clearly defined roles and responsibilities, actions to be taken, time-table for completion of actions, and documented supervisory review and approval of completed actions.

Recommendations: We recommend that:

1. DHS management develop and implement department-wide policies and procedures to ensure compliance with OMB Circular Nos. A-133 and A-50, including the identification of which components must comply. Until policy guidance is received from DHS management, EPR, SLGCP, and TSA should perform the following in fiscal year 2006:
 - a) Develop and implement a tracking system to identify each grantee for which an OMB Circular No. A-133 single audit is required, and the date the audit report is due;
 - b) Use the tracking system to ensure audit and performance reports are received timely, or to follow-up when reports are overdue; and
 - c) Perform reviews of grantee audit reports, issue related management decisions, and ensure that the grantees take appropriate corrective action, on a timely basis.
2. DHS develop policies and procedures, including the development of a process to ensure that corrective action plans addressing all DHS audit findings are developed and implemented, together with appropriate supervisory review.

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Appendix III – Compliance and Other Matters

Q. *Improper Payments Information Act of 2002*

DHS is required to comply with the *Improper Payments Information Act of 2002* (the Act). The Act requires agencies to review all programs and activities they administer annually and identify those that may be susceptible to significant erroneous payments. For all programs and activities where the risk of erroneous payments is significant, agencies must estimate the annual amounts of erroneous payments, and report the estimates to the President and Congress with a progress report on actions to reduce them. The agency must report a statistically valid error projection for susceptible programs in its annual PAR. To facilitate the implementation of the Act, OMB issued guidance in Memorandum M-03-13, *Implementation Guide for the Improper Payments Information Act of 2002*, which among other matters provided a recommended process to meet the disclosure requirements. We noted that DHS did not comply with the Act, as follows:

DHS did not:

- Institute a systematic method of reviewing all programs and identifying those it believed were susceptible to significant erroneous payments; and
- Perform testwork to evaluate improper payments for all material programs. Testing was only performed over the TAFS with the largest disbursements for each component or the largest TAFS maintained by an internal DHS accounting service provider.

Recommendation: We recommend that DHS follow the guidance provided in OMB M-03-13 in fiscal year 2006, including completing the necessary susceptibility assessments, performing testwork over all material programs, and instituting sampling techniques to allow for statistical projection of the results.

R. *DHS Financial Accountability Act of 2004*

Section 3 of Public Law 108-330, *DHS Financial Accountability Act of 2004*, states that the President of the United States shall appoint a Chief Financial Officer of DHS not later than 180 days after the date of the enactment of this Act signed in October 2004, to be confirmed by the U.S. Senate. To date, a CFO for DHS has not been nominated or Senate confirmed. Currently DHS is operating with an Acting CFO, while no waiver or amendment to this law has been obtained by DHS management. The *DHS Financial Accountability Act of 2004* also made DHS subject to the *Chief Financial Officers Act of 1990*, as amended, which requires DHS to submit to the Congress and OMB audited financial statements annually. DHS engaged an independent auditor to audit the September 30, 2005, consolidated balance sheet only.

Recommendation: We recommend that DHS complete the interviewing process and formally nominate an applicant to fill the CFO position in a timely manner. We also recommend that DHS and its components continue to implement corrective action plans in order to remediate the fiscal year 2005 material weaknesses and reportable conditions in order to obtain an opinion covering all of its consolidated financial statements in the future.

S. *Government Performance and Results Act of 1993*

The *Government Performance and Results Act* requires each agency to prepare performance plans that include a description of the operational processes, skills and technology, and the resources required to meet the goals, and a description of the means used to verify and validate the measured results. In addition, the PAR should include performance indicators established in the annual

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Appendix III – Compliance and Other Matters

performance plan, the actual performance achieved compared with the prior year goals, and an evaluation of the current year performance plan with respect to success in achieving the performance goals. The fiscal year 2006 DHS *Annual Performance Plan* did not include details related to requisite resources to meet DHS goals or a description of the means used to verify and validate performance results. Also, DHS did not consistently present performance measures in the PAR as written in the annual performance plans, did not provide explanations of performance results, and did not have supporting documentation substantiating the changes in performance measure goals between the annual performance plan and the PAR.

Recommendation: We recommend that DHS develop policies and procedures to ensure full compliance with the *Government Performance Results Act*.

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Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report		Fiscal Year 2005 Status/Disposition
Material Weaknesses:		
A. Financial Management Structure		Partially Repeated as Material Weakness (Comment A)
Office of the Chief Financial Officer (OCFO) has not fully established processes that bridge the gap between where DHS' consolidated reporting responsibilities lie (at the OCFO) and where most accounting resources and detailed knowledge resides; hired or contracted sufficient qualified personnel to properly perform the financial reporting function; provided the DHS bureaus sufficient management oversight and timely policy guidance; and established sufficient internal controls over financial reporting.		
B. Financial Management and Oversight at Immigration and Customs Enforcement		Repeated as Material Weakness (Comment A)
ICE did not have a well-designed plan for the transition of accounting operations of major DHS directorates and components to its accounting systems, resulting in material errors, irregularities, and abnormal balances in the DHS consolidated financial statements; a process to establish and maintain more than 30 important shared services agreements with trading partners; a process for identifying and fixing deficiencies in its accounting and financial reporting process, including internal control weaknesses, human capital needs, and information technology needs. Its financial systems, processes, and control activities were inadequate for providing accounting services for itself and five other major DHS operating units; sufficient leadership and guidance, from both the OCFO and within its own management ranks. ICE fell seriously behind in performance of basic accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting, which prevented it from submitting timely and accurate periodic financial reports to DHS during fiscal year 2004, correctly applying Federal accounting standards, and implementing internal controls that comply with GAO <i>Standards</i> .		
C. Financial Reporting in the Office of the Chief Financial Officer and DHS Components		Partially Repeated as Material Weakness (Comments A & B)
1. The OCFO did not adhere to the schedule to meet the accelerating reporting deadlines; prepare a balanced consolidated financial statement until November 2004; prepare accurate periodic consolidated financial statements; implement sufficient processes and monitoring controls to ensure consolidated financial information was received timely and was accurate from DHS components; provide adequate guidance to DHS components; and implement procedures and controls over the FMFIA reporting process.		

IV.1

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report		Fiscal Year 2005 Status/Disposition
<p>D. Financial Systems Functionality and Technology</p> <p>OCFO and DHS bureaus have IT and financial system control and functionality weaknesses in entity-wide security program planning and management, access controls, application software development and change controls, system software, segregation of duties, and service continuity.</p> <p>E. Fund Balance with Treasury</p> <p>1. ICE did not perform timely reconciliation procedures for FBWT, and lack SOPs on FBWT reconciliation procedures.</p> <p>2. Guard did not perform timely reconciliation procedures for FBWT, and lack SOPs on FBWT reconciliation procedures.</p>	<p>2. Coast Guard has a reporting process that is complex and requires a significant number of on-top entries, and lacks documentation of internal controls; year-end closing entries did not consistently include sufficient supporting documentation or internal controls, such as management review; the accuracy of financial information was dependent on a few knowledgeable personnel instead of well documented policies and procedures; and had weaknesses in financial management oversight.</p> <p>3. ICE, EPR, and SLGCP do not have documented policies and procedures for exporting data from the general ledger for the TIER submission routinely; quality control procedures over financial reports are not regularly performed; TIER input is not reconciled to outputs provided by the OCFO; and the accuracy of financial information is highly dependent on the knowledge of a few individuals.</p> <p>4. Coast Guard, SLGCP, and ICE did not have effective financial information systems or sufficiently documented processes to accumulate and present cost data by strategic goal as required by SFFAS No. 4.</p> <p>5. EPR monthly TIER transmissions did not accurately and completely reflect the financial transactions of the Strategic National Stockpile.</p> <p>6. SLGCP was not actively involved in the financial reporting process of its accounting services provider, and did not provide adequate oversight.</p>	
		Repeated as Material Weakness (Comment C)
		Repeated as Material Weakness (Comment D)

IV.2

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report		Fiscal Year 2005 Status/Disposition
F. Property, Plant, and Equipment	1. Coast Guard has not implemented appropriate controls and related processes to properly, accurately and timely record PP&E additions, transfers from other agencies, and disposals in its fixed assets system; maintained cost documentation for some PP&E; implemented an adequate asset identification and tagging system; developed a physical inventory processes; accounted properly for depreciation of improvements made for some PP&E; established policies related to the useful lives of certain vessels; properly classified repairable items as PP&E and established procedures to identify and evaluate lease agreements.	Repeated as Material Weakness (Comment E)
	2. ICE has not consistently applied procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development.	
G. Operating Materials and Supplies, and Seized Property	1. Coast Guard procedures and internal controls over physical counts over operating effectively; OM&S was not always properly tagged; on-hand quantities frequently did not agree to the perpetual inventory records; he policies were not updated to ensure correct financial reporting; and the weighted average pricing methodology used to value OM&S was not appropriately supported.	Partially Repeated as Material Weakness (Comment F)
	2. Secret Service counterfeit currency records did not accurately reflect the activity for the year.	
H. Undelivered Orders, Accounts and Grants Payable, and Disbursements	1. ICE did not establish sufficient controls to properly account for disbursements made by legacy agencies for DHS-ICE components; prevent duplicate payments for vendors related to prior year obligations or to prevent anti-deficient situations in certain Treasury accounts; did not have sufficient controls to ensure that open obligations were properly liquidated when corresponding accounts payable were recorded; and did not have policies related to verification and validation of obligations. The methods used by ICE to estimate accounts payable itself and other DHS-ICE components was not based on historical disbursements or other information unique to those programs.	Repeated as Material Weakness (Comment G)

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report		Fiscal Year 2005 Status/Disposition
<p>I. Budgetary Accounting</p> <ol style="list-style-type: none"> ICE has weakness in internal controls that may have allowed it to violate the Antideficiency Act; the transfer of accounting records and responsibilities from prior accounting services providers was not coordinated properly; obligations were not recorded properly; disbursements and resulting adjustments to obligation balances related to CBP were not recorded timely; contracting officer approvals were clearly documented on obligating documents; controls were weak over the preparation and submission of the SF-132 and SF-133 process. Coast Guard, electronic edit checks over budget authority and commitments were not fully employed; weaknesses existed in controls over recording of budgetary authority, commitments, obligations, and related disbursements and recissions; weakness existed in controls over the preparation, submission and document retention of the SF-132 and SF-133; contracting officers with expired authority continued to approve obligations; commitments were not routinely monitored EPR's method of accounting for investments resulted in an audit adjustment to correct the misstatement in the statement of budgetary resources. 	<p>Partially Repeated as Material Weakness (Comment I)</p>	
<p>J. Intragovernmental and Intradepartmental Balances</p> <p>Coast Guard, EPR, CBP, and CIS/ICE do not have effective SOPs to track, confirm, or reconcile intragovernmental balances and transactions with trading partners; and DHS OCFO does not have an adequate process for reconciling differences with other Federal government trading partners.</p>	<p>Repeated as Material Weakness (Comment J)</p>	

IV.4

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report		Fiscal Year 2005 Status/Disposition
Other Reportable Conditions:		
K. Deferred Revenue on Immigration and Naturalization Applications		
CIS lacks SOPs for identifying the accuracy and reliability of application status data and fees correction with immigration applications were not always deposited in accordance with Treasury guidelines.		Closed
L. Environmental Liabilities		
1. Coast Guard have not developed consistent written policies and procedures for the identification, evaluation, and estimation of potential environmental remediation of sites; liability estimates for lighthouses did not include soil testing; did not properly index costs; lacked management review of liability estimates.		Repeated as Reportable Condition (Comment K)
2. S&T had not developed policies and procedures to determine if an environmental liability exists at PIADC, and if so to accurately estimate the liability for financial statement reporting purposes		
M. Custodial Activity Performed by Customs and Border Protection		
CBP did not have a reliable process of monitoring the movement of in-bond shipments, adequate written SOPs, and consistent performance of a compliance measurement program to assess the risk and compute an estimate of underpayment of duties, taxes, and fees.		Repeated as Reportable Condition (Comment L)
Compliance and Other Matters:		
N. Federal Managers' Financial Integrity Act of 1982		
DHS management's FMFIA report did not contain corrective action plans for all material weaknesses identified in the PAR. In addition, DHS and its components have not established effective systems, processes, policies and procedures to evaluate and report on FMFIA compliance.		Repeated as Reportable Condition (Comment M)

IV.5

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report		Fiscal Year 2005 Status/ <u>Disposition</u>
O. <i>Federal Information Security Management Act (Electronic Government Act of 2002)</i> Instances on non-compliance with the FISMA were noted.		Repeated as Reportable Condition (Comment O)
	P. <i>Single Audit Act Amendments of 1996, and Laws and Regulations Supporting OMB Circular No. A-50, Audit Follow-up, as revised</i> EPR, SLGCP, and TSA did not have procedures to monitor grantees and their audit findings.	Partially Repeated as Reportable Condition (Comment P)
Q. <i>Improper Payments Information Act of 2002</i> DHS did not properly define programs and activities, institute a systematic method of reviewing all programs and identifying those at risk of significant erroneous payments, and properly sample or compute the estimated dollar amount of improper payments.		Repeated as Reportable Condition (Comment Q)

IV.6


U.S. Department of Homeland
Security
Washington, DC 20528



Homeland
Security

November 15, 2005

MEMORANDUM FOR: Richard L. Skinner,
Inspector General

FROM: Andrew B. Maner 
Chief Financial Officer

SUBJECT: Management's Response to the Independent Auditor's Report

Thank you for the opportunity to respond to the Independent Auditor's Report. Overall, the Report was well balanced and the Department concurs with the Independent Auditor's recommendations. Detailed corrective action plans for material weaknesses, reportable conditions, and non-compliance with laws and regulations are provided in the Management Discussion and Analysis section of the PAR, however, we would like to take this opportunity to highlight significant actions currently underway to address the material weaknesses reported. Over the next year we will:

- Execute the Secretary's Second Stage Review agenda item for improving DHS financial management.
- Build upon our progress in implementing the *Department of Homeland Security Financial Accountability Act*. Management's assessment for the Act's annual assertion requirement on internal control over financial reporting will be the framework to ensure that all financial management processes across the Department are designed and implemented with strong internal controls.
- Implement a standardized financial reporting process, including formal policies and procedures that require Components to prepare a comprehensive financial reporting package that will result in complete and reliable financial reporting.
- Issue a formal Corrective Action Planning Management Directive and Process Guide to improve our corrective action plans and ensure they demonstrate results.
- Continue to invest in and expand accounting staffs with the right skill sets to improve internal controls over financial reporting.
- Carry on with our efforts to implement a Department-wide IT security program in accordance with OMB and NIST guidance.

Since our inception in March 2003, the Department has demonstrated resolve in subjecting our financial statements to an independent audit. In fiscal year 2006 we will continue to demonstrate our commitment to success in our long-term transformational efforts. Finally, we wanted to reaffirm our appreciation of the efforts of your office and the independent auditors. We are proud of the professional and cooperative working relationships amongst our staffs. Ultimately, we share the common goal of *Organizational Excellence* and we look forward to continuing our joint efforts in developing a culture of integrity, accountability, and excellence in all we do. Once again, thank you for a well balanced report.